NOTE

This Microfiche meets the quality requirements of the American National Standard for Microfiche of Documents (ANSI PH5.9-1975). However, because of imperfections in the document from which it was made, it contains images that are illegible or difficult to read. The source document for this microfiche is the best copy that could be obtained prior to filming.

Congressional Information Service, Inc
Washington, D.C.

CIS

ADMINISTRATION'S FISCAL YEAR 1983 ECONOMIC PROGRAM

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

FEBRUARY 18, 19, 22, 23, 24; MARCH 30, 31; APRIL 1, 2, 5, 6; AND MAY 5, 1982

PART 3

APRIL 5, 6; AND MAY 5, 1982

Serial 97-68

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
99-367 O WASHINGTON : 1982

H781-46

COMMITTEE ON WAYS AND MEANS

DAN ROSTENKOWSKI, Illinois, *Chairman*

SAM M. GIBBONS, Florida
J. J. PICKLE, Texas
CHARLES B. RANGEL, New York
FORTNEY H. (PETE) STARK, California
JAMES R. JONES, Oklahoma
ANDY JACOBS, Jr., Indiana
HAROLD FORD, Tennessee
KEN HOLLAND, South Carolina
WILLIAM M. BRODHEAD, Michigan
ED JENKINS, Georgia
RICHARD A. GEPHARDT, Missouri
THOMAS J. DOWNEY, New York
CECIL (CEC) HEFTEL, Hawaii
WYCHE FOWLER, Jr., Georgia
FRANK J. GUARINI, New Jersey
JAMES M. SHANNON, Massachusetts
MARTY RUSSO, Illinois
DON J. PEASE, Ohio
KENT HANCE, Texas
ROBERT T. MATSUI, California
DON BAILEY, Pennsylvania
BERYL ANTHONY, Jr., Arkansas

BARBER B. CONABLE, Jr., New York
JOHN J. DUNCAN, Tennessee
BILL ARCHER, Texas
GUY VANDER JAGT, Michigan
PHILIP M. CRANE, Illinois
BILL FRENZEL, Minnesota
JAMES G. MARTIN, North Carolina
L. A. (SKIP) BAFALIS, Florida
RICHARD T. SCHULZE, Pennsylvania
BILL GRADISON, Ohio
JOHN H. ROUSSELOT, California
W. HENSON MOORE, Louisiana

John J. Salmon, *Chief Counsel*
Joseph K. Dowley, *Assistant Chief Counsel*
Robert J. Leonard, *Chief Tax Counsel*
A. L. Singleton, *Minority Chief of Staff*

CONTENTS

[PART 1: PAGES 1-793]

[PART 2: PAGES 795-1485]

[PART 3: PAGES 1487-2112]

Page

Press releases announcing hearings 1

INVITED WITNESSES

FEBRUARY 18, 1982

Panel:

- Herbert Stein, Ph. D., senior fellow, American Enterprise Institute for Public Policy Research 4
- Paul A. Samuelson, Ph. D., professor of economics, Massachusetts Institute of Technology 11
- Paul Craig Roberts, Ph. D., senior fellow, Center for Strategic and International Studies 13
- Joseph A. Pechman, Ph. D., director of economics, the Brookings Institution 20
- Martin Feldstein, Ph. D., professor of economics, Harvard University 26

FEBRUARY 19, 1982

W. Michael Blumenthal, chairman of the board and chief executive officer, Burroughs Corp., and former Secretary of the Treasury 65

Panel:

- Morrison H. Beach, chairman of the executive committee, Travelers Insurance Cos 92
- Carl A. Beck, president, Charles Beck Machine Corp., on behalf of the National Small Business Association 99
- James H. Evans, chairman of the board, Union Pacific Corp., and cochairman, the Business Roundtable 106
- Charls E. Walker, chairman, Charls E. Walker Associates, Inc 112

GOVERNMENT WITNESSES

FEBRUARY 22, 1982

Office of Management and Budget, Hon. David A. Stockman, Director 145

Department of the Treasury, Hon. Donald T. Regan, Secretary of the Treasury .. 257

FEBRUARY 23, 1982

Federal Reserve System, Hon. Paul A. Volcker, Chairman, Board of Governors 327

FEBRUARY 24, 1982

Page

Congressional Budget Office, Dr. Alice Rivlin, Director; Nancy M. Gordon, Assistant Director for Human Resources and Community Development; and James M. Verdier, Assistant Director for Tax Analysis 383
Department of Health and Human Services, Hon. Richard S. Schweiker, Secretary 415
Department of Labor, Hon. Raymond J. Donovan, Secretary; Bert Lewis, Administrator, Unemployment Insurance Service; and James Van Erden, Supervisory Actuary 473

MAY 5, 1982

Department of the Treasury, Hon. Donald T. Regan, Secretary of the Treasury .. 2036

PUBLIC WITNESSES

Ad hoc Committee for Small Issue Development Bonds, Chip Morgan 2016
Aerospace Industries Association, John S. Nolan 1379
Albertine, John M., American Business Conference, Inc 887
American Association of Retired Persons, James M. Hacking and Robert Brunner 874
American Bankers Association, Charles A. Bruning and Paul R. Claytor 908
American Business Conference, Inc., John M. Albertine 887
American Council of Life Insurance, Robert F. Froehlke, Robert Ewing, and Richard V. Minck 1462
American Council on Education, Terry Sanford 1891
American Electronics Association, George M. Berman 1338
American Federation of Labor and Congress of Industrial Organizations, Rudolph A. Oswald and Stephen Koplan 829
American Fletcher National Bank, Indianapolis, Ind., Paul R. Claytor 908
American Institute of Certified Public Accountants, James E. Bushman 1394
American Iron & Steel Institute, Robert B. Peabody 1085
American Iron Ore Association, John L. Kelley 1074
American Mining Congress, Paul A. Barrese 1066
American Motors Corp., W. Paul Tippett, Jr 1024
American Public Transit Association, Steve Polan and Peter Strauss 945
Archdiocese of New York, Department of Health and Hospitals, Msgr. James P. Cassidy 1839
Arthur Andersen & Co.:
  William Penick 954
  William D. Barth 889
ASARCO, Inc., Paul A. Barrese 1066
Associated Builders & Contractors, Inc., H. Gregory Johnson and Michael M. Schoor 1439
Associated General Contractors of America, Billy R. Carter 1450
Associated Specialty Contractors, Inc., Robert L. Wilkinson and John Halecky, Jr 1445
Association of American Universities, Terry Sanford 1891
Baldwin, Christopher W., Gannett Co., Inc., and Rochester (N.Y.) Tax Council. 1165
Bankers Life & Casualty Co., Chicago, Ill., Robert Ewing 1462
Bannon, Joan, U.S. Conference of Mayors 1499
Barrese, Paul A., ASARCO, Inc., and American Mining Congress 1066
Barrick, Vera, National Association of Royalty Owners 1645
Barth, William D., Arthur Andersen & Co., and National Small Business Association 889
Beatty, Donald W., Municipal Finance Officers Association 1701
Berman, George M., Unitrode Corp. and American Electronics Association 1338
Black, Samuel H., Council of American-Flag Ship Operators, on behalf of Albert E. May 1351
Bohen, Frederick M., University of Minnesota 1931
Bond, Hon. Christopher S., Governor of Missouri, on behalf of the National Governors' Association 1317
Borman, Frank, Eastern Airlines, Inc 1031
Boston College, John R. Smith 1918
Brophy, Theodore F., Taxation Task Force of the Business Roundtable, and General Telephone & Electronics Corp 1139
Bruning, Charles A., Edgewood Bank, Countryside, Ill., American Bankers Association 908
Brunner, Robert, American Association of Retired Persons and National Retired Teachers Association 874

Page
Bushman, James E., American Institute of Certified Public Accountants 1394
Business Roundtable, Taxation Task Force, Theodore F. Brophy 1139
California Pollution Control Financing Agency, Jesse M. Unruh 1935
Carey, Hon. Hugh, Governor, State of New York 1107
Carlson, Jack, National Association of Realtors 795
Carter, Billy R., Nello L. Teer Co., Durham, N.C., and Associated General Contractors of America 1450
Cassidy, Msgr. James P., Department of Health and Hospitals of the Archdiocese of New York, and Catholic Health Association 1839
Catholic Health Association, Msgr. James P. Cassidy 1839
Chamber of Commerce of the United States, Richard W. Rahn 838
Cherecwich, Paul, Jr., Foxboro Co. and Scientific Apparatus Makers Association 1334
Cincinnati, Ohio, City Council, Peter Strauss 945
Clarfield, Wallace J., the Tax Council, and Olin Corp 902
Claytor, Paul R., American Fletcher National Bank, Indianapolis, Ind., American Bankers Association 908
Clyde, Larry F., Public Securities Association and Crocker National Bank 1736
Coalition of Northeastern Governors, Hon. J. Joseph Garrahy, Governor of Rhode Island 1673
Coffman, Thomas D., Texas Independent Producers & Royalty Owners Association 1641
Cogeneration Coalition, Inc., Michael J. Zimmer 1580
Cohen, Edwin S., Investment Company Institute 925
Columbia Gas System Service Corp., John W. F. Faircloth 898
Committee to Preserve the Completed Contract Method, Leslie J. Schneider 1398
Comstock, L. K., & Co., Inc., Danbury, Conn., John Halecky, Jr 1445
Council of American-Flag Ship Operators, Samuel H. Black on behalf of Albert E. May 1351
Council of Pollution Control Financing Agencies, Jesse M. Unruh 1935
Council of State Hospital Finance Authorities, George C. Phillips, Jr 1807
Council of State Housing Agencies, Thomas W. White 1789
Crocker National Bank, Larry F. Clyde 1736
Curtis, Carl T., National Association of Royalty Owners 1645
Dickey, Charles D., Jr., Scott Paper Co 1017
Dorgan, Hon. Byron L., a Representative in Congress from the State of North Dakota 1127
Duke University, Terry Sanford 1891
Eastern Airlines, Inc., Frank Borman 1031
Edgewood Bank, Countryside, Ill., Charles A. Bruning 908
Ernst & Whinney, Herbert J. Lerner 1278
Ewing, Robert, Bankers Life & Casualty Co., Chicago, Ill., and American Council of Life Insurance 1462
Faircloth, John W. F., Interstate Natural Gas Association of America and Columbia Gas System Service Corp 898
Fisher Pen Co., Paul C. Fisher 1272
FMC Corp., Robert H. Malott 1254
Foxboro Co., Paul Cherecwich, Jr 1344
Frey, Howard H., Westmoreland Coal Co., and National Coal Association 1080
Froehlke, Robert F., American Council of Life Insurance 1462
Gannett Co., Inc., Christopher W. Baldwin 1165
Garrahy, Hon. J. Joseph, Governor of Rhode Island, Coalition of Northeastern Governors 1673
Gazzaway, Gwynne G., National Association of Royalty Owners 1645
General Telephone & Electronics Corp., Theodore F. Brophy 1139
Gershowitz, Harold, National Solid Wastes Management Association, and Waste Management, Inc 1585
Green, Hon. Bill, a Representative in Congress from the State of New York 943
Guthman, Richard, Jr., National League of Cities 1694
Hacking, James M., American Association of Retired Persons and National Retired Teachers Association 874
Halecky, John, Jr., Associated Specialty Contractors, Inc., and L. K. Comstock & Co., Inc., Danbury, Conn 1445
Harkin, Hon. Tom, a Representative in Congress from the State of Iowa 1123
Harris, William R., PPG Industries, Inc 1594
Hawk, Richard C., Higher Education Assistance Foundation 1904
Health Care Financing Study Group, Anthony J. Taddey 1873
Higher Education Assistance Foundation, Richard C. Hawk 1904
Holleman, Wilbur J., National Constructors Association 1425

Page
Huard, Paul R., National Association of Manufacturers ... 846
Illinois Health Facilities Authority, George C. Phillips, Jr ... 1807
Independent Petroleum Association of America, Robert E. Vinson ... 1603
Inland Steel Co., Frederick G. Jaicks ... 1020
Intel Corp., Robert Perlman ... 1331
International Council of Shopping Centers, Wallace R. Woodbury ... 1263
Interstate Natural Gas Association of America, Jerome J. McGrath and John W. F. Faircloth ... 898
Investment Company Institute, Edwin S. Cohen ... 925
Jaicks, Frederick G., Inland Steel Co ... 1020
Johnson, H. Gregory, Associated Builders & Contractors, Inc., and Johnson Electric, Inc., Keene, N.H ... 1439
Johnston, Philip C., Small Business Coalition for Pollution Control ... 1959
Jones, Allan O., National Health-Care Financing Association, Inc ... 1875
Kelley, John L., American Iron Ore Association ... 1074
Koplan, Stephen, American Federation of Labor and Congress of Industrial Organizations ... 829
Laguarta, Julio, National Association of Realtors ... 795
Lerner, Herbert J., Ernst & Whinney ... 1278
Loyola University of Chicago, Paul G. McFarland ... 1926
Machinery & Allied Products Institute, Charles W. Stewart ... 1204
Malott, Robert H., FMC Corp., and Minimum Tax Coalition ... 1254
Marmon Group, Inc., Chicago, Ill., Walter S. Rogowski ... 1940
Martin, Justus C., Jr., Robinson-Humphrey Co., Inc., Atlanta, Ga ... 2009
Massachusetts Industrial Finance Agency, Robert E. Patterson ... 1769
May Albert E. (*See*, Council of American-Flag Ship Operators.)
McFarland, Paul G., Loyola University of Chicago ... 1926
McGrath, Jerome J., Interstate Natural Gas Association of America ... 898
Mields, Hugh, Jr., U.S. Conference of Mayors ... 1499
Mighdoll, M. J., National Association of Recycling Industries, Inc ... 1575
Miller & Schroeder Municipals, Inc., Minneapolis, Minn., F. Warren Preeshl ... 2025
Minck, Richard V., American Council of Life Insurance ... 1462
Minimum Tax Coalition, Robert H. Malott ... 1254
Minnesota, University of, Frederick M. Bohen ... 1931
Missouri, State of, Hon. Christopher S. Bond, Governor ... 1317
Morgan, Chip, ad hoc Committee for Small Issue Development Bonds, and Southern Industrial Development Council ... 2016
Municipal Finance Officers Association, Donald W. Beatty ... 1701
National Association of Independent Colleges and Universities, Terry Sanford 1891
National Association of Manufacturers, Paul R. Huard ... 846
National Association of Realtors, Julio Laguarta and Jack Carlson ... 795
National Association of Recycling Industries, Inc., M. J. Mighdoll ... 1575
National Association of Royalty Owners, James L. Stafford, Gwynne G. Gazzaway, Vera Barrick, and Carl T. Curtis ... 1645
National Association of State Auditors, Comptrollers, and Treasurers, Grady L. Patterson ... 1779
National Coal Association, Howard H. Frey ... 1080
National Committee on Small Issue Industrial Development Bonds, Walter S. Rogowski ... 1940
National Constructors Association, Wilbur J. Holleman ... 1425
National Governors' Association, Hon. Christopher S. Bond, Governor of Missouri ... 1317
National Health-Care Financing Association, Inc., Allan O. Jones and Peter M. Wright ... 1875
National League of Cities, Richard Guthman, Jr ... 1694
National Retired Teachers Association, James M. Hacking and Robert Brunner ... 874
National Small Business Association, William D. Barth ... 889
National Solid Wastes Management Association, Harold Gershowitz ... 1585
New York City, Metropolitan Transportation Authority of, Steve Polan ... 945
New York, State of, Hon. Hugh Carey, Governor ... 1107
Nolan, John S., Aerospace Industries Association ... 1379
Norfolk, Va., city of, Mayor Vincent Thomas ... 1499
O'Brien, Edward I., Securities Industry Association ... 1169
Olin Corp., Wallace J. Clarfield ... 902
Oswald, Rudolph A., American Federation of Labor and Congress of Industrial Organizations ... 829

Page
Patterson, Grady L., State of South Carolina and National Association of State Auditors, Comptrollers and Treasurers 1779
Patterson, Robert E., Massachusetts Industrial Finance Agency 1769
Peabody, Robert B., American Iron & Steel Institute 1085
Penick, William, Arthur Andersen & Co 954
Perlman, Robert, Intel Corp. and Semiconductor Industry Association 1331
Peyser, Hon. Peter A., a Representative in Congress from the State of New York 1487
Phelps Dodge Corp., L. William Seidman 950
Phillips, George C., Jr., Council of State Hospital Finance Authorities, and Illinois Health Facilities Authority 1807
Polan Steve, Metropolitan Transportation Authority of New York City, and American Public Transit Association 945
PPG Industries, Inc., William R. Harris 1594
Preeshl, F. Warren, Miller & Schroeder Municipals, Inc., Minneapolis, Minn 2025
Public Securities Association, Larry F. Clyde 1736
Rahn, Richard W., Chamber of Commerce of the United States 838
Reuss, Hon. Henry S., a Representative in Congress from the State of Wisconsin 1097
Rhode Island, State of, Hon. J. Joseph Garrahy, Governor 1673
Robinson-Humphrey Co., Inc., Atlanta, Ga., Justus C. Martin, Jr 2009
Rochester (N.Y.) Tax Council, Christopher W. Baldwin 1165
Rogowski, Walter S., National Committee on Small Issue Industrial Development Bonds, and the Marmon Group, Inc., Chicago, Ill 1940
Rush-Presbyterian-St. Luke's Medical Center, Chicago, Ill., Karl Zeisler 1863
Sanford, Terry, Duke University; Association of American Universities; American Council on Education; and National Association of Independent Colleges and Universities 1891
Schneider, Leslie J., Committee to Preserve the Completed Contract Method 1398
Schoor, Michael M., Associated Builders & Contractors, Inc 1439
Scientific Apparatus Makers Association, Paul Cherecwich, Jr 1344
Scott Paper Co., Charles D. Dickey, Jr 1017
Securities Industry Association, Edward I. O'Brien 1169
Seidman, L. William, Phelps Dodge Corp 950
Semiconductor Industry Association, Robert Perlman 1331
Small Business Coalition for Pollution Control, Philip C. Johnston 1959
Smaller Business Association of New England, Small Business United, Milton Stewart 1985
Smith, John R., Boston College 1918
South Carolina, State of, Grady L. Patterson 1779
Southern Industrial Development Council, Chip Morgan 2016
Stafford, James L., National Association of Royalty Owners 1645
Stewart, Charles W., Machinery & Allied Products Institute 1204
Stewart, Milton, Smaller Business Association of New England, Small Business United 1985
Stockholders of America, Inc., Margaret Cox Sullivan 931
Strauss, Peter, Cincinnati, Ohio, City Council, and American Public Transit Association 945
Sullivan, Margaret Cox, Stockholders of America, Inc 931
Taddey, Anthony J., Health Care Financing Study Group 1873
Tax Council, Wallace J. Clarfield 902
Teer, Nello L., Co., Billy R. Carter 1450
Texas Independent Producers & Royalty Owners Association, Thomas D. Coffman 1641
Tippett, W. Paul, Jr., American Motors Corp 1024
Thomas, Vincent, mayor of Norfolk, Va., U.S. Conference of Mayors 1499
Unitrode Corp., George M. Berman 1338
Unruh, Jesse M., Council of Pollution Control Financing Agencies and California Pollution Control Financing Agency 1935
U.S. Conference of Mayors, Mayor Vincent Thomas (Norfolk, Va.), Joan Bannon, and Hugh Mields, Jr 1499
Vinson, Robert E., Independent Petroleum Association of America 1603
Waste Management, Inc., Harold Gershowitz 1585
Westmoreland Coal Co., Howard H. Frey 1080
White, Thomas W., Council of State Housing Agencies 1789
Wilkinson, Robert L., Associated Specialty Contractors, Inc 1445
Woodbury, Wallace R., International Council of Shopping Centers 1263
Wright, Peter M., National Health-Care Financing Association 1875

Page
Wyden, Hon. Ron, a Representative in Congress from the State of Oregon 1492
Zeisler, Karl, Rush-Presbyterian-St. Luke's Medical Center, Chicago, Ill 1863
Zimmer, Michael J., Cogeneration Coalition, Inc 1580

SUBMISSIONS FOR THE RECORD

U.S. General Accounting Office, Morton A. Myers, Director, letter and attachments 497

Accardi, Joseph, Watson-Flagg Electric Co., Inc., letter 631
Adley, A. B., Fischbach & Moore, Inc., letter 631
Adventist Health System-West, Frank F. Dupper, letter 505
Air Transport Association of America, statement 507
American Association of State Highway & Transportation Officials, Francis B. Francois, letter 510
American Council for Capital Formation, Charls E. Walker, statement 511
American Gas Association, statement 518
American Hospital Association, statement 521
American Insurance Association, T. Lawrence Jones, statement 523
American Paper Institute, statement 527
American Petroleum Institute, statement and attachments 530
American Protestant Hospital Association, statement 552
American Retail Federation, Loyd Hackler, letter and attachment 554
American Road & Transportation Builders Association, Gerard Swarthout, Jr., statement 557
American Trucking Associations, Inc., statement 558
Anderson, H. L., W. W. Clark Corp., letter 631
Anderson, Richard B., L. K. Comstock & Co., Inc., letter 608
Associated Accounting Firms International, Robert G. Taylor, statement 559
Associated Hospital Systems, Edward J. Connors, letter 560
Association of American Medical Colleges, John A. D. Cooper, M.D., letter 563
Aste, H. Don, Bank Building West, letter 570
Automotive Dismantlers & Recyclers Association, Russell F. McKinnon, statement 566
Baker, Douglas F., Bank Building West, letter 570
Baldwin-Stewart Electric Co., Robert N. Lieder, letter 631
BancOhio National Bank, John L. Staskevich, letter 568
Bank Building West, H. Don Aste, Douglas F. Baker, and Richard R. Larrabure, letter 570
Barbe, Nancy, Counsel for Community Development, Inc., joint statement 612
Barreto, Roger J., Dade County Industrial Development Authority, letter forwarded by Congressman Dante Fascell 620
Bateson, J. W., Co., Inc., John A. Wacker, letter 570
Beach Electric Co., Inc., William Travis, letter 631
Biederman, Kenneth R., New Jersey Department of the Treasury, letter and statement 695
Bromberg, Michael D., Federation of American Hospitals, statement 630
Buffalo Electric Construction Co., Inc., A. A. Caldwell, letter 631
Building Owners & Managers Association International, Gardner McBride, statement 571
Bureson, Maureen, Great Falls, Mont., letter 573
Butcher, Preston, National Multi Housing Council, statement 671
Byrne, Hon. Jane M., mayor of the city of Chicago, Ill., letter 577
Byrom, Fletcher L., Committee for Economic Development, statement 589
Caldwell, A. A., Buffalo Electric Construction Co., Inc., letter 631
Cappadona, Robert S., Mercury Co. of Norwood, Inc., letter 657
Carapellucci, Daniel, National Utility Contractors Association, statement 694
Centex Corp., Frank M. Crossen, letter 574
Chemical Manufacturers Association, statement 575
Chicago, city of, Hon. Jane M. Byrne, mayor, letter 577
Chicago Association of Commerce and Industry, Samuel R. Mitchell, letter 579
Cincotta, Gale, National People's Action, statement 683
Citibank, N. A., John F. Rolph III, letter and attachments 580
Clark, W. W., Corp., H. L. Anderson, letter 631
Committee for Economic Development, Fletcher L. Byrom, statement 589
Commonwealth Edison Co., James J. O'Connor, letter and statement 595
Commonwealth Electric Co., Phillip C. Sheppard, letter and attachment 602

Page

Comstock, L. K., & Co., Inc., Richard B. Anderson, Fred J. Dorsch, Jr., John Halecky, Jr., Charles L. Scharfe, Jr., George E. Wrage, S. P. Valeriano, letter 608
Comstock, L. K., Engineering Co., Inc., Henry A. Dietrich, Joseph R. Dannels, letter 608
Connecticut, State of Hon. William A. O'Neill, Governor, letter 609
Connors, Edward J., Associated Health Systems, letter, and Sisters of Mercy Health Corp., letter 560, 751
Cooper, John A. D., M.D., Association of American Medical Colleges, letter 563
Coopers & Lybrand, statement 609
Council of State Chambers of Commerce, George S. Koch, statement 611
Counsel for Community Development, Inc., Nancy Barbe, Belden Hull Daniels, and Steven Klein, joint statement 612
Craft, Edward O., PHH Group, Inc. and Petersen, Howell & Heather, Inc., joint statement 727
Cregg, George W., Camillus, N.Y., statement 616
Crossen, Frank M., Centex Corp., letter 574
Dade County Industrial Development Authority, Roger J. Barreto, letter forwarded by Congressman Dante Fascell 620
Daniels, Belden Hull, Counsel for Community Development, Inc., joint statement 612
Dannels, Joseph R., L. K. Comstock Engineering Co., Inc., letter 608
Daschle, Hon. Thomas A., a Representative in Congress from the State of South Dakota, statement 502
Davis, Julie W., PHH Group, Inc. and Petersen, Howell & Heather, Inc., joint statement 727
Deevers Electric Co., W. P. Gutekanst, letter 631
Deloitte Haskins & Sells, statement 620
Dietrich, Henry A., L. K. Comstock Engineering Co., Inc., letter 608
Domestic Petroleum Council, statement and attachments 623
Dorsch, Fred J., Jr., L. K. Comstock & Co., Inc., letter 608
Drumwright, Douglas L., Homestake Mining Co., statement 643
Dupper, Frank F., Adventist Health System-West, letter 505
Edison Electric Institute, statement 599
Emery Worldwide, John C. Emery, Jr., letter 629
Federation of American Hospitals, Michael D. Bromberg, statement 630
Fischbach & Moore, Inc., A. B. Adley, letter 631
Fischbach & Moore Electrical Contracting, Inc., W. P. Gutekanst, letter 631
Fischbach & Moore of Alaska, Inc., Ken J. Sutherland, letter 631
Fischbach Corp., Edwin A. Wilinski, letter 631
Fisk Electric Co., J. Chris Jones, letter 634
Foster, William L., Power Systems, Inc., letter 631
Francois, Francis B., American Association of State Highway and Transportation Officials, letter 510
Gandsey, George E., Power Systems, Inc., letter 631
Georgia Residential Finance Authority, Henry M. Huckaby, letter 634
Gray, Herbert W., National Association of Mutual Savings Banks, statement 672
Green, T. H., Electric Co., Inc., Carl R. Swetman, letter 631
Gutekanst, W. P., Deevers Electric Co., Fischbach & Moore Electrical Contracting, Inc., A. S. Schulman Electric Co., letters 631
Hackler, Loyd, American Retail Federation, letter and attachment 554
Halecky, John, Jr., L. K. Comstock & Co., Inc., letter 608
Hawkins, Delafield & Wood, statement 635
Hickok, Richard S., Main Hurdman, statement 653
Higher Education Assistance Foundation, Philip R. Rever, letter and statement 1909
Hinton, Gayford L., Price Waterhouse, letter and statement 734
Holmberg, William B., Kidder, Peabody & Co., Inc., statement 651
Homestake Mining Co., Douglas L. Drumwright, statement 643
Hood, Edwin M., Shipbuilders Council of America, letter and statement 742
Horst Construction, Abram S. Horst, Jr., letter 643
Hospital Financial Management Association, James T. Whitman, letter 644
Huckaby, Henry M., Georgia Residential Finance Authority, letter 634
Illinois, State of, Department of Transportation, John D. Kramer, statement 645
Illinois Road Builders Association, Lawrence R. Lucas, statement 647
International Union, United Automobile, Aerospace & Agricultural Implement Workers of America, UAW, statement 648
Jones, J. Chris, Fisk Electric Co., letter 634

Page
Jones, T. Lawrence, American Insurance Association, statement ... 523
Kidder, Peabody & Co., Inc., William B. Holmberg, statement ... 651
Klein, Steven, Counsel for Community Development, Inc., joint statement ... 612
Koch, George S., Council of State Chambers of Commerce, statement ... 611
Kramer, John D., Illinois Department of Transportation, statement ... 645
Larrabure, Richard R., Bank Building West, letter ... 570
Lieder, Robert N., Baldwin-Stewart Electric Co., letter ... 631
Lohne, Peter M., Bethany, Conn., letter ... 653
Lucas, Lawrence R., Illinois Road Builders Association, statement ... 647
Main Hurdman, Richard S. Hickok, statement ... 653
McBride, Gardner, Building Owners & Manager Association International, statement ... 571
McKinnon, Russell F., Automotive Dismantlers & Recyclers Association, statement ... 566
Mercury Company of Norwood, Inc., Robert S. Cappadona, letter ... 657
Medendorp, David, Power Systems, Inc., letter ... 733
Miller, John, Electric Co., Inc., T. A. Weedmark, letter ... 631
Mitchell, Samuel R., Chicago Association of Commerce & Industry, letter ... 579
Napolitano, Fred J., National Association of Home Builders, statement ... 661
National Association of Counties, Peter Shapiro, statement ... 658
National Association of Home Builders, Fred J. Napolitano, statement ... 661
National Association of Mutual Savings Banks, Herbert W. Gray, statement ... 672
National Association of Private Psychiatric Hospitals, statement ... 676
National Association of Surety Bond Producers, statement ... 678
National Council of Health Centers, statement ... 679
National Multi Housing Council, Preston Butcher, statement ... 681
National People's Action, Gale Cincotta, statement ... 683
National Security Industrial Association, Wallace H. Robinson, Jr., letter ... 689
National Tax Equality Association, Ray M. Stroupe, letter ... 690
National Tooling & Machining Association, statement ... 691
National Utility Contractors Association, Daniel Carapellucci, statement ... 694
New Jersey, State of, Department of the Treasury, Kenneth R. Biederman, letter and statement ... 695
New York State Economic Development Council, Inc., statement ... 713
O'Connor, James J., Commonwealth Edison Co., letter and statement ... 595
O'Neill, Hon. William A., Governor of the State of Connecticut, letter ... 609
Padwe, Gerald W., Touche Ross & Co., letter and attachment ... 763
Peat, Marwick, Mitchell & Co., statement ... 718
Petersen, Howell & Heather, Inc., Edward O. Craft, Julie W. Davis and Dale W. Wickman, joint statement ... 727
Phelps Dodge Communications Co., A. B. Rackelin, Jr., letter forwarded by Congressman Beryl Anthony, Jr ... 1050
PHH Group, Inc., Edward O. Craft, Julie W. Davis and Dale W. Wickham, joint statement ... 727
Power Systems, Inc.:
    William L. Foster and George E. Gandsey, joint letter ... 631
    David Medendorp and John Taylor, joint letter ... 733
Price Waterhouse, Gayford L. Hinton, letter and statement ... 734
Rackelin, A. B., Jr., Phelps Dodge Communications Co., letter forwarded by Congressman Beryl Anthony, Jr ... 1050
Ramp, Floyd L., Richfield, Ohio, statement ... 740
Rau, Charles W., Wisconsin Association of Manufacturers & Commerce, Federal Tax Subcommittee, letter forwarded by Congressman Clement J. Zablocki ... 790
Republic Geothermal, Inc., James R. Stites, statement ... 740
Rever, Philip R., Higher Education Assistance Foundation, letter and statement ... 1909
Robinson, Wallace H., Jr., National Security Industrial Association, letter ... 689
Rolph, John F., III, Citibank, N.A., letter and attachments ... 580
Roukema, Hon. Marge, a Representative in Congress from the State of New Jersey, statement ... 503
Scharfe, Charles L., Jr., L. K. Comstock & Co., Inc., letter ... 608
Schulman, A. S., Electric Co., W. P. Gutekanst, letter ... 631
Shapiro, Peter, National Association of Counties, statement ... 658
Shepherd, Mark, Jr., Texas Instruments, Inc., letter and statement ... 757
Sheppard, Phillip C., Commonwealth Electric Co., letter and attachment ... 602
Shipbuilders Council of America, Edwin M. Hood, letter and statement ... 742
Short, Richard T., Virginia Beach, Va., statement ... 1663

Page
Sisters of Mercy Health Corp., Edward J. Connors, letter 751
Smith, Dan Throop, Hoover Institution, Stanford University, statement 751
Solar Lobby, Suzette Tapper, statement 754
Staskevich, John L., BancOhio National Bank, letter 568
Stites, James R., Republic Geothermal, Inc., statement 740
Stroupe, Ray M., National Tax Equality Association, letter 690
Sutherland, Ken J., Fischbach & Moore of Alaska, Inc., letter 631
Swarthout, Gerard, Jr., American Road & Transportation Builders Association, statement 557
Swetman, Carl R., T. H. Green Electric Co., Inc., letter 631
Tapper, Suzette, Solar Lobby, statement 754
Taylor, Jon, Power Systems, Inc., letter 733
Taylor, Robert G., Associated Accounting Firms International, statement 559
Tax Executives Institute, Inc., statement 756
Texas Instruments, Inc., Mark Shepherd, Jr., letter and statement 757
Touche Ross & Co., Gerald W. Padwe, letter and attachment 763
Travis, William, Beach Electric Co., Inc., letter 631
United States League of Savings Associations, statement 770
Valeriano, S. P., L. K. Comstock & Co., Inc., letter 608
Wacker, John A., J. W. Bateson Co., Inc., letter 570
Walker, Charls E., American Council for Capital Formation, statement 511
Watson-Flagg Electric Co., Inc., Joseph Accardi, letter 631
Weedmark, T. A., John Miller Electric Co., Inc., letter 631
Westchester County (N.Y.) Industrial Development Agency, statement and attachments 777
Whitman, James T., Hospital Financial Management Association, letter 644
Wickham, Dale W., Petersen, Howell & Heather, Inc. and PHH Group, Inc., joint statement 727
Wilinski, Edwin A., Fischbach Corp., letter 631
Wisconsin Association of Manufacturers & Commerce, Federal Tax Subcommittee, Charles W. Rau, letter forwarded by Congressman, Clement J. Zablocki 790
Wood, Nicholas, & Associates, Inc., Nicholas Wood, letter 792
Wrage, George E., L. K. Comstock & Co., Inc., letter 608

ADMINISTRATION'S FISCAL YEAR 1983 ECONOMIC PROGRAM

MONDAY, APRIL 5, 1982

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met at 10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Beryl Anthony, Jr., presiding.

Mr. **Anthony**. The Ways and Means Committee will come to order.

This is a continuation of hearings on the administration's revenue raising proposals. Our first witness today is Hon. Peter A. Peyser, a Member of Congress from New York.

Peter, you are welcome to proceed as you wish. Your entire speech will be placed in the record.

STATEMENT OF HON. PETER A. PEYSER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. **Peyser**. Thank you.

Mr. **Conable**. May I add my welcome to the colleague from New York.

Mr. **Peyser**. Thank you, Mr. Chairman and my good friend Mr. Conable. I do ask that my statement be put in the record. I will merely make some comments on the issue at this time. Then of course, I will welcome any questions that might be forthcoming.

In the first place, I do want to state how pleased I am that the Ways and Means Committee is directing itself, and has been over the last several weeks, to the question of how to raise revenues. It is to that issue that I have introduced H.R. 4460 which now has 80 cosponsors, both Democrat and Republican.

Basically what H.R. 4460 tries to do is to repeal the sections of the Economic Recovery Tax Act which changed the windfall profits tax. While it is hard to estimate, due to fluctuating oil prices the exact impact, the estimates we have received over the next 3 to 4 years range anywhere from $6 to $11 billion in revenue that could come back to the Federal Government.

Now, I know it is not the purpose specifically of these hearings to relate to other programs, but I just find it very difficult to ignore the fact that one of the changes that we made last year as well, was the change in the social security benefit for students attending college effective as of May of this year unless legislation similar to the legislation that one of your own committee members, Mr.

Downey, goes into effect. This year's high school seniors are "shut out" of the program. His legislation would simply defer the ending of this program until October 1982. There is sound reason for this, of course. Since the Social Security Administration officials themselves did not notify eligible students correctly of what was happening, in fact, sent out hundreds of thousands of pieces of misinformation which they have admitted to, and now have changed. I believe we have an obligation to correct this mistake and provide an orderly transition period.

But, as of now it is too late for most of these students. So, hopefully, the Downey measure might receive some activity in the committee. I know if it reaches the floor, it would pass. But the point of all this is that in 1 year, under the most conservative estimates, the moneys coming back from windfall profits tax, even though they have by legislation been targeted to other areas, would be more than triple the amount of money necessary to continue the social security benefit until October for the hundreds of thousands of students who would be impacted by this cut.

I sometimes wonder, Mr. Chairman, when I see the action of the administraion in a matter such as this, whether the Reagan administration really believes that we have an economic problem that has to be addressed by doing something. One of the easiest, and, I think, most practical methods that would do the least harm in recouping billions of dollars for the Treasury is by changing that section of the windfall profits tax back to what it was when it originally passed Congress. And I would urge, Mr. Chairman, that your committee, on both sides of the aisle, really give serious consideration to this.

Such a suggestion obviously reflects the thinking of Republicans and Democrats, a large number of whom feel that we perhaps acted hastily and moved in a way that was not in the best interest of the country, and certainly not in the best interest of those who are affected by the cutbacks in funds that have been made.

It is for this reason, Mr. Chairman, that I welcome this opportunity to briefly state this message. I think that the committee hopefully is going to move in this direction. And for the chance to give one more plug for the young people of this country, I hope that when we realize the amount of money that can be recouped by this type of action, we will also look favorably on reinstating the social security post-secondary education benefit that is severely hurting so many of our young people in this country.

I thank you, Mr. Chairman, and members of the committee, for letting me appear before you this morning.

[The prepared statement follows:]

STATEMENT OF HON. PETER A. PEYSER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. Chairman, I appreciate the opportunity to appear before you and other Members of this Committee as you begin the process of considering initiatives to increase Federal Revenues.

Your task of combing through the varying suggestions and competing interests to structure a revenue raising package that achieves a substantial reduction in the looming triple-digit deficit will be a demanding and complex undertaking, but one which is of utmost urgency. If we are to overcome the current economic crisis, it is imperative that we take real, long-standing strides toward reducing the crippling deficit.

Because of the many revenue raising proposals being offered, I wanted to take this time to focus the Committee's attention on one proposal which many Members believe should be included in any comprehensive revenue raising legislation. Nearly 80 of our colleagues from both sides of the aisle have joined me in sponsoring H.R. 4460, which repeals certain of the excessively charitable "Windfall Profit Tax" cut provisions of last year's Economic Recovery Tax Act. This legislation repeals three of the four sections which lowered the windfall profit tax: section 601, the 3 barrels per day royalty exemption; section 602, the reduced taxation rate on newly discovered oil; and section 603, the independent producer exemption for stripper well oil. The exemption for the oil interests of non-profit child care agencies from the windfall profit tax is preserved.

By repealing these three provisions of the Economic Recovery Tax Act, we would in effect be doing nothing more than reinstating the windfall profit tax at the levels originally passed by Congress in 1980. Those levels were fairly set and should not have been lowered in the tax cutting fervor of last year. As the Committee stated in the report accompanying the Windfall Profit Tax legislation, "The revenues resulting from these higher prices (due to decontrol) would provide income to oil producers far in excess of what most of them originally anticipated when they drilled their wells and in excess of what they might now be expected to invest in energy production. . . the windfall profit tax in this bill will tax away a fair portion of this additional revenue."

Of the arguments surrounding the many revenue raising measures being weighed by this Committee, none seem as compelling as those for reinstating the windfall profit tax to the pre-1981 Economic Recovery Tax Act levels. The cuts in the windfall profit tax constituted nothing less than a massive giveaway from the well-heeled industry. The oil industry has realized huge profits from the decontrol of oil prices, and contrary to the industry's claim that they would use their new found largess for exploration, drilling and increased domestic production, more than 50 percent of the additional income received by the top oil companies since oil prices were decontrolled has been used for non-petroleum purposes, including purchases of other companies, investments and dividends to stockholders.

With the oil industry benefiting from the general tax breaks available to all businesses and industries from the Economic Recovery Tax Act, it was unnecessary to single out the oil industry and reward it with an extra tax cut. It is estimated that over the coming decade, oil and gas interests will save at least $50 billion in federal taxes under the Accelerated Cost Recovery System for depreciation. There is no reason to maintain this generous bonus in light of the onerous deficit.

Since the reduction of the windfall profit tax in last year's Economic Recovery Tax Act wasn't a part of the President's initial tax reduction package, restoration of the windfall profit tax to the original levels of the windfall profit tax legislation would not compromise any of the President's economic recovery initiatives. It would be a positive step forward toward reducing the growing deficit, without moving back from the President's position.

With the projections for oil prices have been revised downward since last August, the estimates of the revenue to be gained from the restoration of the windfall profit tax to the original levels would not be quite as high as the $10.3 billion from 1983 through 1986 indicated in the Conference Report to the Economic Recovery Tax Act, but the revenue gain would still be substantial. Most recent estimates by CBO place the income to the Treasury from a repeal of these provisions to be about $7.4 billion dollars by 1987. Predicting oil prices, however, is a real dicey game. The last decade has shown that oil prices are in a constant state of flux. While prices may have dropped, the lesson learned from recent history is that prices will likely rise again for some unexpected reason at some unexpected time. So, by the beginning of the next decade, when the windfall profit tax is scheduled to end, Federal revenues from a reinstated windfall profit tax could meet the higher projection.

Mr. Chairman, the budget cutting actions of this Congress last year imposed great hardship on many people. While I recognize that the revenues from the windfall profit tax go into a trust fund to finance spending on alternative energy programs and to provide low-income energy assistance, I wanted to draw this Committee's attention to a different program where additional revenues could offset the damage done from last year's cuts. As we all know, the Social Security Administration failed to properly and timely notify high school seniors who receive a student benefit of their eligibility for post-secondary benefits. I believe we have an obligation to extend from May until October the period in which these students can become enrolled in a college or university to retain their eligibility for the post-secondary benefits. The revenue from just the first year of a reinstated windfall profit tax would be about $900 million, more than three times the amount necessary to correct this unjustice.

In light of the immense profits in the oil industry, the reduction in the windfall profit tax was unnecessary, its inclusion in a tax reduction package for the purposes of stimulating the economy wasn't justified, and its retention under the shadows of a $120 billion dollar deficit isn't warranted. I am sure that Members who face the prospects of a second round of budget cuts in programs affecting the elderly, students, or the disabled, or those Members especially troubled by excessive defense cuts would be pleased to reinstate the windfall profit tax at the original levels. Mr. Chairman, on behalf of all the Members who have joined me in sponsoring legislation to correct this excess of last year's tax act, I respectfully request that this Committee include provisions reinstating the windfall profit tax to the pre-1981 levels in any comprehensive revenue raising measure reported to the floor.

COSPONSORS OF H.R. 4460, AS OF MARCH 24, 1982

Mr. Barnes, Mr. Bedell, Mr. Beilenson, Mr. Bingham, Mr. Boland, Mr. Bonior, Mr. Bonker, and Mr. Brown.

Mrs. Chisholm, Mr. Clay, Mrs. Collins of Illinois, Mr. Conte, Mr. Conyers, Mr. Crockett, Mr. D'Amours, Mr. Dellums, Mr. Dwyer, Mr. Dymally, and Mr. Edgar.

Mr. Edwards of California, Mr. Evans of Indiana, Mrs. Fenwick, Ms. Ferraro, Mr. Fish, Mr. Florio, Mr. Foglietta, Mr. Ford of Michigan, Mr. Frank, Mr. Gejdenson, Mr. Gilman, and Mr. Gore.

Mrs. Heckler, Mr. Hollenbeck, Mr. Hoyer, Mr. Hughes, Mr. Jeffords, Mr. Kastenmeier, Mr. Kildee, Mr. Kogovsek, Mr. LaFalce, Mr. Leach, Mr. Long of Maryland, Mr. Lowry of Washington, Mr. Markey, and Mr. Mazzoli.

Ms. Mikulski, Mr. Minish, Mr. Mitchell of Maryland, Mr. Mitchell of New York, Mr. Mollohan, Mr. Mottl, Mr. Murphy, Mr. Nelligan, Mr. Oberstar, Mr. Pepper, Mr. Rahall, Mr. Rangel, Mr. Ratchford, Mr. Reuss, Mr. Richmond, and Mr. Rosenthal.

Mrs. Roukema, Mr. Sabo, Mr. Savage, Mr. Schamansky, Mr. Schumer, Mr. Seiberling, Mr. St Germain, Mr. Stokes, Mr. Vento, Mr. Walgren, Mr. Walker, Mr. Weiss, Mr. Wolpe, Mr. Yates, and Mr. Yatron.

Mr. ANTHONY. Thank you, Mr. Peyser.

Mr. Conable, do you have questions?

Mr. CONABLE. I have no questions.

Mr. ANTHONY. Mr. Frenzel, do you have questions?

Mr. FRENZEL. I have no questions. I want to thank the gentleman for his fine statement.

Mr. ANTHONY. Peter, I do not think I can let you off quite as easily as my two colleagues did. I would like to just ask you a couple of questions concerning the proposal that you have to repeal the tax provisions that were contained in the tax package for 1981 for independent oil producers and small royalty owners.

I happen to represent a region that happens to have a lot of independent oil producers, and also a great many small royalty owners. Their position is contrary to what you say on page two about the cuts in the Windfall Profits Tax came from a well-heeled industry.

Now, I would ask you if you would be willing to amend your piece of legislation to the extent that it would not affect people who do receive small amounts of royalty on a monthly basis. To give you some idea of what happens, I have a lot of, say, widow women or elderly people that have retired, but through the years, they do have some oil income coming in the form of a royalty. They are neither drillers, nor are they oil company people. But the way the tax is applied against them, it took 33 percent of their income away, which means that if they were making $30 a month in royalty income, the tax took a third of it away and brought it down to 20, which was a fairly substantial amount. They were just trying to get a little bit of equity brought back into the Tax Code and not be treated as the large oil companies.

Mr. PEYSER. Let me say that I fully appreciate the problem. It has never been my intention in any legislation to strike at people who are the poorer people or the people who are suffering themselves under the administration's programs. I guess the real question comes in with regard to the smaller royalty holders is if we are really creating a hardship for them by cutting back.

Obviously, I guess their royalties must have increased over the last two or three years, or last four or five years, really, just based on what has happened to oil and because of decontrol. And, it was the decision when we originally drew this legislation that the tax impact on the small producer would still leave the small producer for instance substantially ahead in royalties than they were in 1975 or 1976, even with taking back this small segment that we gave them this last year.

Now, those are the figures we received. I think they are correct. But I realize it still is cutting back. I would like to say, I think they are still substantially ahead of where they were five years ago on the royalty, even with this cutback.

Mr. ANTHONY. Some of the questions that I have been forced to answer myself would be, well, why does the government not tax all other huge increases in revenue in a given period of time because of economic circumstances? And it is complicated, and it is hard to answer. That is the reason I ask you to just take a close look at some of the subtleties that are involved in this, and that some of the small royalty owners could be hurt by having the provisions taken back.

Also, take a close look at the independent oil producers, that is, the wildcatters who go out, and, in the past, have found most of our oil, as opposed to the 16 major oil companies.

I know you did make a mention where that additional income had been spent. I do not think that the same study would show that to be true with independents because they are not out buying up companies, they are out spending money to drill.

So, there is a distinction to be made between the majors, the independents and small royalty owners. The only thing that I ask you and your colleagues to do is to acknowledge that the small royalty owners and independents should not be put in the same category with the majors.

Mr. PEYSER. Mr. Chairman, we would certainly be willing to look at this when we come closer to a tax package. I think we could see whether a reasonable adjustment might be made in that particular area. But it certainly is the feeling that the profit level has risen so substantially. As far as taxing others, I don't really know of any other instance in any other industry frankly, that is comparable to this problem where we have seen the kind of a situation that developed due to both the international implications of energy and the source of energy in this country.

Most of our other industries are knee deep in troubles at this point, and Windfall Profits Tax would be something they would welcome if we could tax them for it.

Mr. ANTHONY. Yes, I understand. I would just ask you and your colleagues to take another look at what decontrol has done.

The original argument for decontrol was that it would provide the incentives and that it would eventually cause prices to go down. That is exactly what has happened. In fact, drilling rigs now are stacking up because of lack of activity. So, take a look at what the impact of your legislation would do again in an area where there is already some slow down.

Mr. **Peyser**. I assure you again that we would be willing to do that. I guess one of the things, when we look at Windfall Profits Tax in any fashion that has affected a lot of our thinking, is to see, now dealing with the larger oil companies, that they have moved themselves, and as a business person you can understand, into fields having nothing to do with oil research and development, and the seeking of new energy sources. As you know, the oil companies have moved into everything from the movies to hotel chains to a multitude of things which obviously they are doing with tremendous profits that they have been making.

Mr. **Anthony**. Well, I appreciate you appearing before the committee. I would say we would be happy to work with you. Mr. Stark, do you have questions?

Mr. **Stark**. No, Mr. Chairman.

Mr. **Anthony**. Thank you.

Mr. **Peyser**. Thank you very much, Mr. Chairman.

Mr. **Anthony**. Our next witness is the Honrable Ron Wyden, a Member of Congress from Oregon.

Ron, welcome back before the committee.

STATEMENT OF HON. RON WYDEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON

Mr. **Wyden**. Thank you very much, Mr. Chairman. It is always a pleasure to be with you and I very much appreciate my colleagues giving me this opportunity to testify today.

I am here in support of my bill, H.R. 5340, which would extend the 1982 deadline for business energy tax credits under the Windfall Profit Tax Act of 1980. I introduced this measure because I believe an investment in business energy tax credits is an investment in our future, an investment that I think we quite literally cannot afford to pass up in this country.

H.R. 5340 is a straightforward piece of legislation and has a simple purpose. The business energy tax credit in question which we can really call the cogeneration tax credit, is due to expire December 31, 1982, unlike the majority of the conservation investment credits authorized under the Windfall Profit Tax Act, which do not expire until 1985.

By limiting the scope of H.R. 5340 to an extension of the cogeneration credit, I hope to encourage this Congress to act quickly. To fail to do so would be to perpetuate an air of uncertainty that only deters business, particularly the small business community, from making the cost-effective energy investments.

Because we are pressed for time this morning I would like to confine my remarks in support of extending the cogeneration tax credit to just three major points. The first is the benefits of the tax credit as a business investment, as something that will boost productivity in this country.

Second, the benefits of the tax credit as an insurance policy against energy supply vulnerability.

Third, the cost of the tax credit to the Treasury versus its long-range revenue raising potential.

First, let me clarify that I refer to this credit as a cogeneration tax credit for shorthand purposes only. In reality, the credit applies to waste recycling equipment, equipment that converts coal into synthetic fuels or that uses coal as a feedstock, and other miscellaneous equipment such as heat exchangers, waste heat boilers and automatic energy control system as well as to cogeneration equipment not fueled by oil or gas.

I think we all understand that business, particularly small business, is in a bind today. Energy costs for the small business community are rising. In fact, for many firms, energy costs represent the fastest growing component of their cost structure.

For example in 1976, energy spending in the primary metals industry on a proportional basis represented more than 200 percent of pretax profits compared with only 59 percent in 1966. Similarly in the pulp and paper industry which is one of the mainstays of my home State, Oregon's, economy—energy spending account for more than 80 percent of pretax profits in 1976, up from 45 percent in 1966.

But, in an era of spiraling interest rates and chronic inflation, the up-front capital needed to change this situation is nearly impossible to come by.

The name of the game in periods of tight money is cash flow. That is where the cogeneration tax credit comes in. By providing immediate, up-front capital, it will encourage industry to purchase cogeneration equipment, boilers and burners that use fuels other than oil and natural gas, and conservation equipment.

The benefits can be seen not only in terms of energy saved—but also in terms of job stability, job creation and economic growth.

After installing $11 million worth of cogeneration equipment, the president of a malting company in Washington State recently announced he would not only make money by selling power to the local utility, but would also be able to better guarantee his 150 employees that there will be jobs for them in the coming years.

The president of a small investment/brokerage firm in Oregon wrote to me:

> In view of the cost-effectiveness of these alternate energy sources, literally dozens of engineering, investment banking and law firms have invested substantial time in bringing themselves up to date in the area and now offer necessary support services.
>
> Over the next few years, if the investment and energy tax credits are continued, a flurry of projects will be designed, financed, constructed and brought on line. To remove such credits at this critical time, would pull the rug out from nearly every such project now on the drawing boards.

The question we have got to ask ourselves is why, then did the Treasury's Office of Tax Policy conclude in an October, 1981 memo that a majority of Members of Congress would support repeal because they realize the "credits are ineffective."

Really, the answer is the Government has stood in the way of widespread use of the credit. Despite the existence of the cogeneration credit for more than 2 years now, the Treasury Department has yet to adopt final regulations setting out the investments that can qualify for the credit.

Thus, business has been unable to determine the parameters of the credit; unable to ascertain with certainty whether the conservation investments they had in mind would even qualify for the credit.

I think we ought to make it very clear that the Treasury Department's failure to act is reprehensible. Congress stated its intent that these credits be available to business. By failing to implement the regulations to provide business with the proper guidelines, the Treasury Department has subjected business to the arbitrary whims of a faceless bureaucracy.

If Congress allows the credit to simply expire at the end of this year, it will have only compounded the problem by turning its back on an experiment that was never given a chance to blossom.

The second argument on this matter is that it is an insurance policy against energy vulnerability. One of the strongest arguments on behalf of extending the cogeneration credit, is the energy conservation/energy independence argument.

Our dependence on foreign oil—still equal to 40 percent of our daily consumption—and the increasing instability in the Middle East are constant reminders of our permanent window of vulnerability. It is a window through which we export roughly $50 billion per year to pay for our imported oil.

To close this window somewhat, we have embarked upon a $100 billion venture to create a Rapid Deployment Force to protect the oilfields in the Middle East.

I submit that a far more cost-effective means of closing this window is to pay an annual premium of roughly $100 million in foregone tax revenues to insure steady progress and stability in the development of a viable and permanent investment in industrial energy efficiency and to facilitate the utilization of domestic coal.

The price of this policy is the true price of our security. I believe we get much more bang for the buck from the tax credit, as the potential energy efficiency gains in the industrial sector are endless. By emphasizing alternate energy sources, we can save now as well as for the future.

It has been estimated that the immediate potential for energy savings through cogeneration equal 45,000 megawatts, or roughly the equivalent of 45 new thermal powerplants—and at far less cost.

Over the long haul, potential improvements in energy efficiency brought about through extension of the tax credit, could result in savings of the equivalent of 5 million barrels of oil per day by the year 2000—the amount we presently import.

The last major argument I want to touch on, Mr. Chairman, is that the cogeneration tax credit, quite literally, pays for itself.

A study by Arthur D. Little, Inc., issued in November, 1981, shows that over the long-haul, increased treasury revenues will outweight the losses. According to that report, for a given investment, in the year of the equipment's purchase, one can expect:

First, decreased tax revenues from providing tax credits.

Second, increased tax revenues from the economic activity induced by the alternative energy investment.

Over an assume 20-year life of the investment, the report showed: First, decreased tax revenues from the increased depreciation and operation/maintenance expenses, which are tax deductible;

Second, increased tax revenue from the decrease in fuel costs, which are tax deductible under section 162 of the Internal Revenue Code; and

Third, decreased tax revenues on the profits and wages of the companies that provided electricity and natural gas to the firm undertaking the conservation equipment investment.

The overall impact on Treasury revenues, according to the report, under an assumed energy inflation rate 9 percent above the general inflation rate, is:

> The net present value of the increase in revenue due to the decrease in tax deductible corporate expenses for conventional energy is large enough that the Treasury will actually profit on the tax credit program.

Given today's oil glut, some may question the propriety of an analysis using an energy inflation rate 9 percent above the general inflation rate. But I think we all understand that history has proven the danger of being lulled into a false sense of security by declining energy prices and I won't go through those statistics in the sake of time.

The bottom line is that for every dollar of energy use saved by the investment, the Treasury in effect recovers increased tax revenues—revenues which would not have been collected but for the energy-saving capital expenditures.

In conclusion, I can only say that to forego extension of the cogeneration tax credit is to forego energy savings, energy independence, industrial expansion, and job security for Americans. And that is a price we can ill-afford to pay.

My legislation, H.R. 5340, already enjoys the bipartisan support of some 30 of my colleagues, I hope the members of this committee will join us in pushing for its passage.

Thank you.

[The prepared statement follows:]

STATEMENT OF HON. RON WYDEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON

INVESTING IN OUR FUTURE: THE CASE FOR EXTENDING THE BUSINESS ENERGY TAX CREDIT

Thank you, Mr. Chairman and members of the Committee, for allowing me to testify today in support of my bill, H.R. 5340, which would extend the 1982 deadline for business energy tax credits under the Windfall Profit Tax Act of 1980.

I introduced this measure because I believe an investment in business energy tax credits is an investment in our future—an investment we, quite literally, cannot afford to pass up.

H.R. 5340 is a simple, straightforward piece of legislation—and for a purpose. The business energy tax credit in question (hereinafter, referred to as the cogeneration tax credit) is due to expire December 31, 1982, unlike the majority of the conservation investment credits authorized under the Windfall Profits Tax Act, which do not expire until 1985.

By limiting the scope of H.R. 5340 to an extension of the cogeneration credit, I hoped to encourage Congress to act quickly. To fail to do so, would be to perpetuate an air of uncertainly that only deters business from making cost-effective energy investments.

In the interest of time, I will confine my remarks in support of extending the cogeneration tax credit to three major points:

(1) The benefits of the tax credit as a business investment—and a productivity booster; (2) The benefits of the tax credit as an insurance policy against energy

supply vulnerability; and (3) The cost of the tax credit to the Treasury versus its long range revenue-raising potential.

But first, let me clarify that I refer to this credit as a cogeneration tax credit for shorthand purposes only. In reality, the credit applies to waste recycling equipment, equipment that converts coal into synthetic fuels or that uses coal as a feedstock, and other miscellaneous equipment such as heat exchangers, waste heat boilers and automatic energy control system—as well as to cogeneration equipment not fueled by oil or gas.

The benefits to business

Business today is in a bind. Energy costs for business are rising; in fact, for many firms, energy costs represent the fastest growing component of their cost-structure.

For example, in 1976, energy spending in the primary metals industry, on a proportional basis, represented more than 200 percent of pre-tax profits, compared with only 59 percent in 1966.

Similarly, in the pulp and paper industry—one of the mainstays of my home state, Oregon's, economy—energy spending accounted for more than 80 percent of pre-tax profits in 1976, up from 45 percent in 1966.

But, in an era of spiraling interest rates and chronic inflation, the up-front capital needed to change this situation is nearly impossible to come by.

The name of the game in periods of tight money is cash flow.

That's where the cogeneration tax credit comes in. By providing immediate, up-front capital, it will encourage industry to purchase cogeneration equipment, boilers and burners that use fuels other than oil and natural gas, and conservation equipment.

The benefits can be seen not only in terms of energy saved—but also in terms of job stability, job creation and economic growth.

After installing $11 million worth of cogeneration equipment, the president of a malting company in Washington State recently announced he would not only make money by selling power to the local utility, but would also be able to "better guarantee" his 150 employees that there will be jobs for them in the coming years.

And the president of a small investment/brokerage firm in Oregon wrote to me: "In view of the cost effectiveness of these alternate energy sources, literally dozens of engineering, investment banking and law firms have invested substantial time in bringing themselves up to date in the area and now offer necessary support services. Over the next few years, if the investment and energy tax credits are continued, a flurry of projects will be designed, financed, constructed and brought on line. To remove such credit at this critical time, would pull the rug out from nearly every such project now on the drawing boards.

Why then, did the Treasury's Office of Tax Policy conclude in an October, 1981, memo that a majority of members of Congress would support repeal because they realize the "credits are ineffective?"

Because the government has stood in the way of widespread use of the credit. Despite the existence of the cogeneration credit for more than two years now, the Treasury Department has yet to adopt final regulations setting out the investments that can qualify for the credit.

Thus, business has been unable to determine the parameters of the credit; unable to ascertain with certainty whether the conservation investment they had in mind would qualify for the credit.

I find the Treasury Department's failure to act reprehensible. Congress stated its intent that these credits be available to business. By failing to implement the regulations necessary to provide business with the proper guidelines, the Treasury Department has subjected business to the arbitrary whims of a faceless bureacracy.

And if Congress allows the credit to simply expire at the end of this year, it will have only compounded the problem by turning its back on an experiment that was never given a chance to blossom.

An insurance policy against energy vulnerability

One of the strongest arguments on behalf of extending the cogeneration credit, is the energy conservation/energy independence argument.

Our dependence on foreign oil—still equal to 40 percent of our daily consumption—and the increasing instability in the Middle East are constant reminders of our permanent window of vulnerability.

It is a window through which we export roughly $50 billion per year to pay for our imported oil.

To close this window somewhat, we have embarked upon a $100 billion venture to create a rapid deployment force to "protect" the oilfields in the Middle East.

I submit that a far more cost-effective means of closing this window is to pay an annual premium of roughly $100 million in foregone tax revenues to ensure steady progress and stability in the development of a viable and permanent investment in industrial energy efficiency and to facilitate the utilization of domestic coal.

The price of this policy is the price of our security.

I believe we get much more bang for the buck from the tax credit, as the potential energy efficiency gains in the industrial sector are endless.

And by emphasizing alternate energy sources, we can save now—and for the future.

It has been estimated that the immediate potential for energy savings through cogeneration equals 45,000 megawatts, or roughly the equivalent of 45 new thermal power plants—and at far less cost.

Over the long haul, potential improvements in energy efficiency brought about through extension of the tax credit, could result in savings of the equivalent of 5 million barrels of oil per day by the year 2000—the amount we presently import.

The cogeneration tax credit pays for itself

We can predict these kinds of savings because the cogeneration tax credit, quite literally, pays for itself.

A study by Arthur D. Little, Inc., issued in November 1981, shows that over the long-haul, increased revenues will outweigh the losses.

According to that report, for a given investment, in the year of the equipment's purchase, one can expect: Decreased tax revenues from providing tax credits; and increased tax revenues from the economic activity induced by the alternative energy investment.

Over an assumed 20-year life of the investment, the report showed: Decreased tax revenues from the increased depreciation and operation/maintenance expenses, which are tax deductible; increased tax revenue from the decrease in fuel costs (as you know, energy expenses are deductible under section 162 of the Internal Revenue Code as "ordinary and necessary" business expenses) and; decreased tax revenues on the profits and wages of the companies that provided electricity and natural gas to the firm undertaking the conservation equipment investment.

The overall impact on Treasury revenues, according to the report, under an assumed energy inflation rate 9 percent above the general inflation rate, is: "* * * The net present value of the increase in revenue due to the decrease in tax deductible corporate expenses for conventional energy is large enough that the Treasury will actually profit on the tax credit program."

Given today's oil glut, some may question the propriety of an analysis using an energy inflation rate 9 percent above the general inflation rate.

But history has proven the danger of being lulled into a false sense of security by declining energy prices.

In just a couple of months in 1973 and 1974, the price of oil jumped from $3 per barrel to $14 per barrel.

And in 1979, again in the space of a few short months, the price of oil jumped to $40 per barrel.

The bottom line is that for every dollar of energy use saved by the investment, the Treasury in effect recovers increased tax revenues—revenues which would not have been collected but for the energy-saving capital expenditures.

CONCLUSION

In summary, I can only say that to forego extension of the cogeneration tax credit is to forego energy savings, energy independence, industrial expansion, and job security for Americans.

And that is a price we can ill-afford to pay.

H.R. 5340 already enjoys the bipartisan support of some 30 of my colleagues. I hope the members of this committee will join us in pushing for its passage.

Thank you.

Mr. ANTHONY. Thank you very much, Ron.

Mr. Conable, do you have questions?

Mr. CONABLE. No, I don't. I do think cogeneration is a very interesting subject and one that is getting a great deal of attention. Like you, I hope we won't move away from the energy conservation tax credits.

Mr. **Wyden**. I appreciate that comment. In particular the industries with the least capital up front, pulp and paper for example in my area in Oregon, are the ones with the greatest potential for cogeneration.

I think that is why we should make sure in that area there are significant inducements for development.

Mr. **Anthony**. Mr. Stark?

Mr. **Stark**. I have no questions.

Mr. **Anthony**. Mr. Frenzel?

Mr. **Frenzel**. I have no questions. I thank the gentleman for his testimony.

Mr. **Anthony**. I saw Mr. Downey and Mr. Pickle. Ron, I would like to thank you for appearing before the committee and talking about cogeneration. I have a lot of pulp and paper companies in my district and in the South. We have moved into utilizing cogeneration to a great extent because of so much bark waste that has already been bought when you purchased the tree, and it is being utilized now for providing energy and saving natural gas.

I think you are right on target. I give you great encouragement to continue to push it. I think you will find some strong support on this committee to keep in the conservation tax credits.

Mr. **Wyden**. I very much appreciate those comments, Mr. Chairman. I think there really is an analogy between the problems the South faces and the problems of the Northwest. I think that comment about the small investment firm which does work in timber and pulp and paper products, the point is that a lot of these projects are on line right now. If we suddenly derail the train, don't extend the tax credit, a lot of those projects are just going to go by the boards.

The area you are talking about, the South and my area of the Northwest, the Midwest which is very involved in primary metals development, those are going to be the areas that are hard hit. We need them for our economic recovery in this country.

Mr. **Anthony**. I just have one problem with, not only your proposal but with this proposal in general, my family business for instance happens to be in the wood products industry. We saw the natural gas price escalation coming.

So, before any tax credits were put on the books, we went out and invested in a cogeneration facility only to see the law passed a few months later and not made retroactive so we didn't get the tax credits, although we thought we were being very good managers.

Others who sat tight had the Government help pay for their costs through the tax credit. Any time you do get into a situation like this you do create some discrepancies out in the marketplace.

I do not know how we can go about resolving those types of problems, but at least I would like to bring it to your attention so you can take a look at your piece of legislation and see if there is any way that particular problem could be addressed for those companies who, on their own initiative go out and do it without the Government encouraging them through tax credits. Yet they are not given any benefits through the Tax Code.

It makes it a little bit harder for those people to compete when other people do get in later on.

Mr. **Wyden**. I think your point is a very good one. Of course, if everybody's eyes weren't fixated on revenues, perhaps there would have been a chance to go further back even before 1980. I think that is a very valid point. Hopefully now we are going to figure out a way to permanently lock into our Tax Code some system of incentives so that people don't fall through the cracks like you are talking about in the South.

Mr. **Anthony**. I would specifically like to bring your attention to section 17 of that particular provision that talks about an exclusion for public utility property.

It says the terms alternate energy property, biomass property, solar or wind energy property, recycling equipment and cogeneration property do not include property which is public utility property.

I just ask you to do a study as to if it is extended, whether that particular section should be taken out and amended so that public utilities would be allowed to get into this area. I have found that in my State of Arkansas, where there is a desire for the public utilities to do that and to get involved on a cost-sharing basis with private industry, that they are prohibited from doing so by the Tax Code.

It is an area that I have been looking into. So, I encourage you to take a look at that section.

Mr. **Wyden**. I would be very, very supportive of an amendment like that, Mr. Chairman. And of course, it is the will of the committee and the concern about how much revenue can be allocated to this kind of situation that will govern. But the amendment that you speak of, I would be very supportive of personally.

Mr. **Anthony**. Sounds very good. Thank you for coming.

Mr. **Wyden**. Thank you.

Mr. **Anthony**. The next witness represents the U.S. Conference of Mayors, Vincent Thomas, mayor of Norfolk, Va.

Is Mr. Thomas here?

STATEMENT OF VINCENT THOMAS, MAYOR OF NORFOLK, VA., ON BEHALF OF THE U.S. CONFERENCE OF MAYORS, ACCOMPANIED BY JOAN BANNON, ASSISTANT EXECUTIVE DIRECTOR, U.S. CONFERENCE OF MAYORS AND HUGH MIELDS, JR., PLANNING CONSULTANT AND GOVERNMENTAL AFFAIRS

Mr. **Thomas**. Good morning, Mr. Chairman.

Mr. **Anthony**. Mr. Thomas, I see you have some people who accompanied you, if you would like to introduce them for the record, we would be pleased to have their names associated with your appearance.

Mr. **Thomas**. Joan Bannon is on the staff of the U.S. Conference of Mayors and Hugh Mields is the city's representative here in Washington.

Mr. **Anthony**. Thank you. You may proceed as you wish.

Mr. **Thomas**. Mr. Chairman and members of the Ways and Means Committee, thank you for this opportunity for the U.S. Conference of Mayors to testify on industrial revenue bonds (IRB's) and the other tax proposals of the administration for fiscal year 1983.

While my comments are on behalf of the U.S. Conference of Mayors, I would note that my city, an urban area celebrating its tricentennial this year, actively pursues a revitalization program, making extensive use of industrial development revenue bonds. We have developed a substantial experience in this area and on the basis of that experience offer the following as reasonable constraints which we currently utilize:

One, every IRB is considered and acted upon at public hearings which are publicly disclosed prior to the approval of any IRB. Two, both the ultimate holder of the bond and all parties at interest are publicly disclosed prior to the approval of any IRB. Three, all IRB activities are reported at least annually to our local and State governments.

Four, prior to approval of any IRB issue, its impact on local taxes, employment, economic development objectives, and environment are publicly considered. Five, periodically, policy objectives are established at public hearings. The most recent such policy hearing was held this past Thursday, April 1. I have a copy of a newspaper article covering that meeting and would like to introduce it into the record as well as introduce my written testimony.

Mr. Anthony. Yes; your entire statement will be accepted for the record, and as an addendum we would accept the newspaper article.

Mr. Thomas. Thank you, sir. Six, detailed financing information of the issuer is required and reviewed. And also the buyer if he is not an established recognized organization like a bank or some similar organization.

Seven, while the total volume of IRB's issued has increased in recent years, the significant increase in both number of issues and dollar volume has occurred because of our active encouragement of small businesses to utilize the IRB vehicle for their acquisitions and expansions. We have standardized and streamlined procedures to reduce to an absolute minimum the administrative costs that have to be borne by those small businesses.

Eight, we recognize the subsidy provided by such financing through the reduced Federal tax liabilities of the recipients of interest on IRB obligations. We believe such subsidies are more than offset by the reduced interest expense deduction and corresponding increased tax liabilities of the borrowers, the increased local tax revenue derived from expanded physical facilities and the material increase in local employment. Again adding tax revenues and reducing social costs.

We believe that our use of IRB financing has materially benefited our community, is vital to our continued economic health, and has encouraged a material expansion in employment and local tax revenues. This has been accomplished with almost negligible adminsitrative costs, both at the local and Federal level. The reported abuses elsewhere and suggested negative financial impact on Federal, State and local revenues, we believe, is not supported by the Norfolk experience and we encourage a thorough, objective review of our experience.

In addition we are working in the U.S. Conference of Mayors to establish a set of voluntary guidelines that all of our colleagues will be encouraged to adhere to to reduce the chance of any abuses.

We are also deeply concerned by the administration's proposal to include interest expenses incurred by banks to buy or carry tax-exempt securities as a preference item in determining the minimum tax imposed on corporations.

This has been estimated by the municipal finance offices to cost State and local government $1.3 billion in the first year alone, and we feel would wreak havoc on the municipal bond market. We must not give the banks any encouragement to unload or not to buy municipal issues, and we think the minimum tax would have that result. Given the immense infrastructure needs of local governments these days, many of which are postponed because of high interest rates it is absolutely necessary that banks are not given disincentives as far as these bonds are concerned. We are concerned about some of the proposed restrictions on the issuance of small issue industrial revenue bonds which are in part an economic development for central cities, helping to attract new firms, to create job opportunities and to improve the local tax base by increased investment in land, buildings, and machinery.

The conference recommends that the issuance of IRB's should be accomplished at public hearing with the adequate public notice and coverage by the press. If it is deemed advisable that the highest elected official or legislative body pass on these isues, we would request that city councils and similar bodies be allowed to delegate the responsibility to a board or commission which holds regularly scheduled public meetings. We also support appropriate periodic public reporting of these issues. Our local procedures require a disclosure of the impact on local taxes, employment, economic development objectives, and environment prior to the issuance of an IRB.

We recommend your consideration of similar procedures. We are pretty tough about this, and we don't grant every request, and we send applications back for more information if that is needed. We can justify every project on the basis of public interest.

We are also concerned about the matter of requiring a choice between the accelerated cost recovery system and the IRB's. We think this is an issue to be discussed, but we are worried about the impact it may have on private entrepreneurs working on solid waste and resource recovery projects. Also, we think that impacted or distressed areas should have the benefits of both of these incentives.

Also, we are opposed to the very tight limits proposed on the size of businesses which can benefit from small issue IRB's. The $20 million might possibly be all right for my city, but as the scale goes upward in larger cities, that might not be enough. And also, major manufacturing installations would require certainly higher limits in many cases. We are very concerned about any requirements for a local commitment which would impact heavily on distressed communities. Reservations about the Treasury Department's restrictive earnings worry us to the extent that this might interfere with public projects undertaken by cities. We are opposed to the repeal of energy tax credits which Congressman Conable just commented on. These tax credits are very important.

So, Mr. Chairman, gentlemen, and members of the committee, in summary the Conference of Mayors is concerned about the imposition of a proposed minimum tax on corporate debt used to purchase state and local bonds. We are opposed to some of the proposed restrictions on industrial revenue bonds and the repeal of tax provisions which encourage energy conservation.

I thank you for the privilege of testifying.

[The prepared statement follows:]

STATEMENT OF MAYOR VINCENT THOMAS, NORFOLK, VA., ON BEHALF OF THE U.S. CONFERENCE OF MAYORS

Mr. Chairman, Members of the Ways and Means Committee, thank you for this opportunity for the U.S. Conference of Mayors to testify on industrial revenue bonds (IRB's) and the other tax proposals of the Administration for fiscal year 1983.

While my comments are on behalf of the U.S. Conference of Mayors, I would note that my City, an urban area celebrating its tri-centennial this year, actively pursues a revitalization program, making extensive use of industrial development revenue bonds. We have developed a substantial experience in this area and on the basis of that experience offer the following as reasonable constraints which we currently utilize:

(1) Every IRB is considered and acted upon at public hearings which are reported in the local press.

(2) Both the ultimate holder of the bond and all parties at interest are publicly disclosed prior to the approval of any IRB.

(3) All IRB activities are reported at least annually to our local and State governments.

(4) Prior to approval of any IRB issue, its impact on local taxes, employment, economic development objectives and environment are publicly considered.

(5) Periodically, policy objectives are established at public hearings. The most recent such policy hearing was held this past Thursday, April 1.

(6) Detailed financing information of the issuer is required and reviewed.

(7) While the total volume of IRB's issued has increased in recent years, the significant increase in both number of issues and dollar volume has occurred because of our active encouragement of small businesses to utilize the IRB vehicle for their acquisitions and expansions.

(8) We recognize the subsidy provided by such financing through the reduced Federal tax liabilities of the recipients of interest on IRB obligations.

We believe such subsidies are more than offset by the reduced interest expense deduction and corresponding increased tax liabilities of the borrowers, the increased local tax revenue derived from expanded physical facilities and the material increase in local employment.

We believe that our use of IRB financing has materially benefitted our community, is vital to our continued economic health, and has encouraged a material expansion in employment and local tax revenues. This has been accomplished with almost negligible administrative costs, both at the local and Federal level. The reported abuses elsewhere and suggested negative financial impact on Federal, State and local revenues, we believe, is not supported by the Norfolk experience and we encourage a thorough, objective review of our experience.

The Conference of Mayors is deeply concerned by the Administration's proposal to include interest expenses incurred by banks to buy or sell tax exempt securities as a preference item in determining the minimum tax imposed on corporations.

The impact of this proposal on the state and local bond market has not been fully analyzed by the Treasury Department. According to a preliminary study of the Municipal Finance Officers Association, the cost to state and local governments will total over $1.3 billion in the first year alone—hardly an insignificant amount. We are concerned that such a proposal will wreak further havoc on the municipal bond market, already reeling from the effects of high interest rates, Federal and state budget cutbacks, declining municipal credit ratings, the effects of last year's tax law, federal limitations on state and local bonds, and the general uncertainty currently prevailing in the market.

Banks are the largest holder of state and local bonds, especially short-term securities, and to the extent they must pay taxes on debt used to carry such bonds, they will have less incentive to purchase our securities. The result is likely to be an unprecedented dumping of our bonds and much higher interest and borrowing costs for cities.

Given the immense infrastructure needs of local governments for highways, bridges, sewer and water systems, it is important that we have the continued support of the banks and other financial institutions in order to obtain the huge sums of capital needed to finance these public projects in the years ahead.

Secondly, we are concerned about some of the Administration's proposals to restrict the issuance of small issue industrial revenue bonds. Small issue industrial revenue bonds are an important economic development tool for central cities, helping to attract new firms, to create job opportunities, and improve the local tax base by increased investment in land, buildings, and machinery.

Recognizing that existing legislation requires the investment of funds derived from IRB financing, almost exclusively in land, buildings, and machinery, all of which is subject to local taxation, we would propose the following for your consideration:

(1) The issuance of IRB's should be accomplished at public hearings, with adequate public notice and with full disclosure of the holders of the bonds and all parties in interest of the issuing entity.

(2) If this Committee, in its wisdom, determines that the highest elected official or legislative body of the jurisdiction should assume the additional burden of reviewing and passing on each IRB issue, I would request that we be permitted to delegate this responsibility to a board or a commission which holds a regularly scheduled public meeting detailed in (1) above.

(3) We support appropriate periodic public reporting requirements for IRB's.

(4) Our local procedures require disclosure of the impact on local taxes, employment, economic development objectives and environment, prior to issuance of an IRB and we recommend your consideration of similar procedures.

We are concerned about the proposal to require that assets financed by IRB's must forego the use of accelerated depreciation under the provisions of the Accelerated Cost Recovery System (ACRS). The U.S. Conference of Mayors is concerned that many necessary projects, such as resource recovery and solid waste will be in jeopardy. Private entrepreneurs, operating these projects have warned us that such activities are often marginal enterprises during their early years and require both the use of IRB financing and ACRS.

The use of both ACRS and IRB financing are, we believe, important for continued development in certain urban areas. Toward this end, we would encourage your favorable consideration of both of these vehicles in Urban Development Action Grant areas.

In addition, we are opposed to the very tight limits proposed on the size of businesses which can benefit from small issue IRB's. The $20 million capital expenditure limitation will prevent many central cities from using IRB's to attract private industry and create manufacturing jobs. This is an important and justifiable economic development objective of many cities, where wages and income levels are low and unemployment is high.

Additionally, we are concerned about one other Treasury proposal—the requirements of a one percent local commitment. While the one percent local contribution is not required until January 1, 1986, the Conference of Mayors is troubled that such a requirement will have the perverse effect of penalizing those distressed cities and areas that most need the benefit of IRB's. Certainly, it is likely to be easier for a wealthier community to generate the financial commitment than for a poorer, heavily taxed jurisdiction. We urge your recognition that a majority of state constitutions prohibit any local financial commitment to private development. At the very least, we urge this Committee to waive this provision for distressed communities.

Finally, we also have some reservations about the Treasury Department's restricting earnings on reserve funds and funds held during the construction period. To the extent this provision interferes with public projects undertaken by cities, we are opposed to its implementation.

One final point with respect to the President's tax proposals. The repeal of business energy tax credits, as proposed by the Administration, seems to us to be shortsighted. Although the energy crisis is no longer of immediate concern, it remains a long-range problem. The Conference of Mayors believes the federal government should continue to encourage energy conservation. We are particularly distressed at the proposed repeal of the tax provisions which allow local governments to issue tax-exempt bonds for solid waste and similar energy facilities.

Mr. Chairman, in summary, the Conference of Mayors is concerned about the imposition of the proposed minimum tax on corporate debt used to purchase state and local bonds, some of the proposed restrictions on industrial revenue bonds, and the repeal of tax provisions which encourage energy conservation.

Thank you for this opportunity to testify on the President's proposed tax changes. We look forward to working with you to design a tax bill which meets the important needs of our urban areas and our low- and middle-income taxpayers.

[From the Ledger (Norfolk, Va.) Star, Apr. 2, 1982]

NORFOLK TO CONTINUE ISSUING INDUSTRIAL BONDS

(By John Levin, Staff Writer)

NORFOLK.—Norfolk will continue to issue tax-free industrial bonds to lure industry here despite growing national criticism that prosperous firms should not get a financing break.

"It makes no difference whether a developer can afford to do a project. With industrial bonds you're trying to create an environment in which it makes economic sense to open a business," said Doyle E. Hull, a banker and member of the Norfolk Industrial Development Authority, which issues the bonds.

The authority, at a special meeting Thursday evening, decided to continue issuing bonds after weighing seven months of intense criticism by Congress that similar authorities across the country are abusing the tax-free bonding.

Convinced the Norfolk group is not one of the abusing authorities, NIDA Chairman Raymond L. Gottlieb said restrictions being proposed on the bonding law nonetheless "will be very disastrous for urban places like Norfolk."

In the past two years of high interest, both large and small companies have asked industrial development authorities for bonds that allow them to borrow money from banks and other major lenders at about two-thirds the market rates.

The discount results from the money lender not having to pay income tax on proceeds from a loan backed by industrial bonds.

The law allowing such bonding is based on the premise that the public is best served by having industries providing jobs and adding to a community's tax base.

In recent months the Norfolk authority has grappled with the criticisms but, despite them, issued $1 million in industrial bonds to General Mills Inc., the Minneapolis-based food processor, to build a restaurant on Military Highway, and $3.8 million in bonds to Bethesda, Md., developer Arnold Orleans for his renovation of the Hotel Madison on Granby Mall.

It rejected however, a $500,000 request from Wendy's International Inc., of Dublin, Ohio, for a fast-food operation on Little Creek Road.

"The criticism is coming about national chains such as K Mart that go into communities and seek industrial bonds when they have adequate financing to build without the tax break," Gottlieb said.

But Hull countered, "When you're dealing with record-high interest rates, our industrial development bonds have made all the difference in the world in determining whether developers do something.

"Orleans could have afforded the Madison project without tax-free bonding but he wouldn't have done it without the bonds," Hull said.

"The question is not whether developers can afford to build, but whether the buildings perform the reasons we are here," to provide jobs and greater tax revenue, said NIDA member Robert D. Hecht.

"There is no question that this bonding is a subsidy. Perhaps the problem in Washington is that it requires no bureaucracy to administer it," Hull said.

"It is one of the cheapest forms of industrial and economic development that's been created.

"You can see what's happened to the nation's housing industry by removing its federal subsidies and exposing it to the marketplace," Hull said.

"And you can assume that would happen to commercial real estate development without this subsidy and developers were forced to pay conventional mortgage rates."

Although the authority did not take a formal vote on the policy, it agreed informally to arm Mayor Vincent Thomas with its views when he testifies on industrial revenue bonds Monday in Washington before the House Ways and Means Committee.

Mr. ANTHONY. Thank you very much, Mr. Thomas, for your testimony.

Mr. Conable, do you have any questions?

Mr. CONABLE. Thank you, also, Mayor Thomas.

I want to ask you if there is any concern among the mayors of the country about possible excessive use of tax-exempt bonds?

I understand last year, for instance, that for the first time, tax-exempt bonds for private purposes exceeded bonds for public purposes.

We obviously got to the point where we fought off the market and impeded the opportunities for traditional municipal finance. That is, of course, one of the concerns we have here.

The Federal Government loses revenue when tax-exempt bonds are issued. But that is beside the point.

We do have a potential problem of the proliferation of tax-exempt bonds affecting the market, distorting the traditional spread between tax-exempt and taxable bonds, and seriously impinging on what has been an extremely valuable tool for traditional municipal finance.

Now, is the Conference of Mayors concerning itself with this problem, or because tax-exempt bonds offer such a flexible and valuable tool in tax-exempt industry, is there a tendency to look somewhere else and assume Congress is going to look at the issue?

Mr. Thomas. I think we have a tendency to universalize everything.

In answer to your question the Conference of Mayors is deeply concerned about the abuses in this program, and concerned also about the narrowing of the spread between tax-exempt and taxable issues.

I think, though, that we have to look at the whole situation in terms of the current economic conditions facing the country.

It would seem to me that any moves which tend to restrict our economic development at this time should be very carefully considered before they are put into place. The effect on the spread between taxable and nontaxable issues, by putting restrictions on IRB's, would be minimal compared to the impact of an overall reduction of the level of long-term interest rates.

We are seeking to encourage additional economic activity, and in Norfolk at this stage of the game, IRB's are just about the only game in town. Last year we closed 32 issues for a total of about $36 million, just a little over an average of $1 million an issue. But we have about 32 others which have not been closed yet and are not being closed because of other economic conditions.

Now, I would have to ask, would we be better off locally and nationally having those issues closed, or not closed? I would have to conclude that we would be better off from a standpoint of tax base and jobs and relief of social costs such as unemployment and welfare and food stamps, that we would be much better off with those closed.

I recognize that we have a long-range problem in this regard. But I don't think that now is the time to restrict tools for economic development.

Mr. Conable. Well, if now is the time, the question always is when, and that is obviously our responsibility here as well as the responsibility of those who use these tools. I appreciate that there is great concern about the economy out there. And that we are likely to continue to be concerned about the economy for some time.

I hope your Conference will worry a little about the extent to which we can destroy the tool by overusing it.

Mr. **Thomas.** Well, that is why we intend to address ourselves to a voluntary constraint program within the Conference, to talk our colleagues, all of them, into the absolutely necessity to be responsible in the handling of these incentive bonds.

Mr. **Conable.** Thank you. Thank you, Mr. Chairman.

Mr. **Anthony.** Mr. Frenzel, do you have questions.

Mr. **Frenzel.** Yes, Mr. Chairman, I have some of the same concerns that apparently are troubling Mr. Conable.

Some of my mayors at home are a little nervous that industrial development revenue bonds are affecting their markets for general obligation bonds and causing their prices to go up.

I am concerned because I am afraid that nothing is getting built anymore without using municipal financing.

In my area, nobody builds a plant anymore unless it is built with an industrial revenue bond mixed in with a little tax increment financing and heavily seasoned with a UDAG grant.

What has happened is that we no longer have bankers in my area; we have city councils. And city councils frequently are not very good bankers. But they are the only ones around, and people who want to make a business investment know they don't have to go to the traditional market because the city council is going to give them what they want, which is the lowest possible financing.

And so any business manager would be, I think, subject to severe criticism if he took a more expensive form of financing.

When you say it is the only game in town, you are dead right. But that is because it is there. And a manager would be a fool to finance any other way.

How many of those 36 that you have completed this year would have occurred anyway without your financing?

Mr. **Thomas.** Well, of course, that is really the point. There has been criticism about companies, big companies that could well afford to do things getting the advantage of industrial revenue bonds.

From an economic development standpoint, the question is not whether the company can afford the money; it is whether the project itself can carry the debt load that it must carry and operate in the marketplace. That is, as I say, we have some that have been approved but not issued.

And the reason is because the economy is very tight, and they simply can't put the whole deal together.

What I am saying is that economic development in my city, I believe, would generally come to a halt without IDB's, given the state of the current economy. Maybe when the economy picks up, when interest rates go down and maybe some better spread occurs between taxable and nontaxable, we can consider doing away with these items.

But I have personally been worried about the cuts in many of our economic development programs, many, for instance, in the Department of Commerce, that have come at a time when we are trying desperately to build the economy back up.

So I think that now is not the time to consider restrictions on this very important economic development tool.

Mr. **Frenzel.** Well, I thank you for your testimony. We on this committee are not going to want to lay any more distress on an already distressed economy, and we don't want to frustrate your efforts to improve your local areas.

But we are a little nervous about making the general taxpayers of the United States the underwriters for all of the industrial development of the United States. And it is coming to be more and more that.

We think some of it ought to be your responsibility, and not all of it ours.

Thank you, Mr. Chairman. I yield the balance of my time.

Mr. ANTHONY. Mr. Vander Jagt.

Mr. VANDER JAGT. No questions.

Mr. ANTHONY. Mr. Thomas, thank you very much for your testimony. I have a couple of inquiries.

You say that there are 32 issues totaling $36 million that you have utilized in your community, and that you have 32 issues that are now pending. Of the 32 issues for $36 million, you say that some have been approved, but have not actually been issued.

Mr. THOMAS. That is right. Thirty-two inducement resolutions passed in 1981 are still outstanding.

Mr. ANTHONY. Could you submit for the record the types of industries and purposes that those 32 do represent?

Mr. THOMAS. The 32 outstanding? Yes, sir.

Mr. ANTHONY. Yes. I think it would also be helpful, if you also have 32 pending.

Mr. THOMAS. All right. We will put a brief justification, public justification of each project, because just standing on their face you might have some questions just to look at it on the lift. But we will tell you how we justified that project from the public interest standpoint.

Mr. ANTHONY. Any that make you nervous, as far as this committee taking a look at them, you put as much justification as you want to on them.

Mr. THOMAS. All right.

Mr. ANTHONY. What I would like to see for the record is how your community has utilized them, after having gone through the extensive checklist of procedures utilized before the bonds are approved and issued.

I think that is very constructive. If we could take a look and see how that procedure has actually been put to use in practicality, we see how it reads, it reads very nicely.

But if we could compare what you say you do with what you have actualy done in practice, we may have a better idea of how to curb some of the so-called abuses.

If you could also indicate in that list the ones that were rejected, also.

Mr. THOMAS. All right, sir.

Mr. ANTHONY. And maybe some indication of why they are rejected, I think that would be very instructive to the committee as we try to determine if there is some abuse and how to go about curbing that abuse.

[The following was subsequently received:]

INDUSTRIAL DEVELOPMENT REVENUE BONDS IN 1981

Amount of Issue	Name of Concern
$ 275,000	The Tomato House
2,500,000	Toys "R" Us
250,000	Charles T. Parker
750,000	Military Distributors of Va., Inc.
200,000	Military Distributors of Va., Inc.
50,000	Military Distributors of Va., Inc.
900,000	The Bute Company
500,000	Ralph Groves
500,000	Cygnet Communications
400,000	Codi Associates
3,500,000	Madison Hotel Limited Partnership
300,000	Richard E. Beck
2,000,000	Commonwealth Foods, Inc.
500,000	Oil Equipment Properties
1,750,000	Ecolochem, Inc.
200,000	Gerald M. & Ruth H. Zeno
400,000	George Stenke & Josephine Stenke
2,000,000	Ralston Purina Company
400,000	Ulysses T. Brown & Joseph Dondell
3,870,000	Medical Tower Associates
194,000	Donning Properties
475,000	Norfolk Food Factory Associates
600,000	Henry Laurel Co., Inc.
425,000	Vincent L. Reca & Laura G. Reca
1,550,000	Marine Hydraulics International, Inc.
700,000	CBA Properties
3,675,000	Day Realty of South Carolina, Inc.
250,000	Sidney Popkin & Richard E. Popkin
500,000	MMM Design Group
250,000	H. M. Webb & Associates
1,500,000	21st - High Properties
1,445,000	21st - High Properties
340,000	AtlanticAir, Limited
500,000	Standard Office Supply, Inc.
1,900,000	Brambleton Medical Associates
1,000,000	Redgate Medical Associates

INDUSTRIAL REVENUE BONDS PENDING IN 1981

Proposed Amount of Issue	Name of Concern
$ 1,500,000	Prospect Hill Resources, Inc.
1,600,000	Board of Trade Associates
1,500,000	E. Marvin Slaughter
220,000	Woodrow W. Ford, Jr. & Emerson K. Land
350,000	Pier Associates, Inc.
1,000,000	Marine Hydraulics International, Inc.
200,000	PH Associates
1,700,000	Village Avenue Investors, Inc.
150,000	Milton Kramer/Kramer Tire Company
500,000	Milton Kramer/Kramer Tire Company
300,000	Ralph R. Futterman, D.D.S.
800,000	J. Gerard Zoby & Henry L. Sadler
325,000	Joshiah H. Woodington & Marjorie Woodington
750,000	Arthur Friedman & Ralph Kopelove
4,000,000	George G. Phillips
2,200,000	Herman E. Valentine
2,250,000	Norfolk Community Nursing Center
5,000,000	N.B.C. Container Line, Inc.
900,000	Earl W. Walker, Jr./Hampton Roads Oil Co.
1,350,000	Ballard Fish & Oyster Co., Inc.
400,000	Seaward Marine Services, Inc.
1,700,000	Bank of the Commonwealth
1,000,000	General Mills, Inc.
2,500,000	C & A Investment Company
750,000	Bruce Longman & Associates
750,000	Schenkers International Forwarders, Inc.
725,000	Korman Realty Company
500,000	Schaubach Associates
2,000,000	Oppenheimer Norfolk Associates
8,000,000	Burlage Corporation
4,000,000	Goodman & Company
300,000	Lew D. Derrickson & Robert C. Baydush

INDUCEMENT RESOLUTIONS NOT APPROVED IN 1981

Amount of Issue	Name of Concern
$ 1,000,000	Wendy's International, Inc.

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. Applicant Information:

a) Name of applicant: The Tomato House, Incorporated

b) Business address: 4564 Progress Road
Norfolk, Virginia 23502

c) Legal entity: (individual, partnership or corporation): Corporation

d) Name and title of official representative: William A. Garringer, President

e) Business telephone: Company 855-0173 Representative 855-0713

f) Principal business of applicant Wholesale produce, buying and selling

2. Bond Issue Information:

a) Amount of bond issue $ 275,000.00

b) Maturity 20 years-probably will have a call provision after 7 years Years

c) Proposed purchaser of bond(s) Central Fidelity Bank

d) Name of purchaser contact Frank E. Booker, III, Vice President

e) Has commitment been issued? Tentative commitment If so, please attach a copy.
Attached is a copy of the November 6, 1980 letter from Central Fidelity Bank

3. Project Information:

a) Location of improvements 4564 Progress Rd., Norfolk, Virginia

b) Brief narrative description of improvements to be financed 109' x 110' building with 8 shipping and receiving doors of which 109' x 60' will be a cooler plus related equipment and parking lot.

4. Community Benefits of Project:

a) Employment: (Estimated impact of project) Additional 10-20 employees.

b) Additional local taxes to be paid Approximately $2,000.00 property taxes per year.

c) Other benefits The corporation will be able to expand its services which will provide additional tax revenues to the community and possible expansion of employment.

9. **Describe the manner in which the issuance of the requested bond(s)** will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

The issuance of the requested bond will be an inducement for The Tomato House, Incorporated to continue its business in the City of Norfolk by allowing it to expand the services to its customers. This will include the installation of a processing room for chopping and vacuum packaging of lettuce and other produce for ready prepared salads for resturants, hospitals, etc.

Signed: W. A. Garr

Applicant: The Tomato House, Incorporated

By: William A. Garranger, President
(Title)

Date: November 12, 1980

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
   - a) Name of applicant: TOYS "R" US, INC.
   - b) Business address: 395 West Passaic Street
     Rochelle Park, New Jersey 07662
   - c) Legal entity: (individual, partnership or corporation): Corporation
   - d) Name and title of official representative: Michael Paul Miller, Vice President-Real Estate
   - e) Business telephone: 201-845-9322 Company 201-845-9322 Representative
   - f) Principal business of applicant Retail toy sales
2. **Bond Issue Information:**
   - a) Amount of bond issue $ 2,500,000
   - b) Maturity Purchase and terms not yet finalized. Years
   - c) Proposed purchaser of bond(s)
   - d) Name of purchaser contact
   - e) Has commitment been issued? No If so, please attach a copy
3. **Project Information:**
   - a) Location of improvements 400 Military Highway
   - b) Brief narrative description of improvements to be financed Purchase of 4.2 acres of land and construction of a 43,000 sq. ft. retail building.
4. **Community Benefits of Project:**
   - a) Employment: (Estimated impact of project) 70 year-round, permanent employees; 150 seasonal October - December
   - b) Additional local taxes to be paid Total estimated taxes including real estate personal property, city sales, and retail merchants - $100,000/annum.
   - c) Other benefits This store payroll - $375,000/year.

9. Describe the manner in which the issuance of the requested bond(s) will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

Without financial assistance from the Authority via Industrial Revenue Bond Financing, the Company may decide, for economic reasons, not to open a store in Norfolk, Virginia.

Signed:
Applicant: TOYS "R" US, INC.
By: Vice President (Title)
Date: August 19, 1980

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. Applicant Information:

a) Name of applicant: CHARLES T. PARKER

b) Business address: 3301 N. Military Highway
Norfolk, Virginia

c) Legal entity: (individual, partnership or corporation): individual

d) Name and title of official representative: Charles T. Paker

e) Business telephone: Company 853-2424 Representative 853-2424

f) Principal business of applicant: Retail, wholesale and manufacture of audio, lighting and musical equipment systems

2. Bond Issue Information:

a) Amount of bond issue: $ 250,000.00

b) Maturity: 25 years callable after 10 years x~~Years~~

c) Proposed purchaser of bond(s): CODI associates, a Virginia partnership

d) Name of purchaser contact: Barry S. Comess

e) Has commitment been issued? copy of option attached If so, please attach a copy.

3. Project Information:

a) Location of improvements: 3301 N. Military Highway, Norfolk, Virginia

b) Brief narrative description of improvements to be financed: Purchase of land and a 12,000 sq. feet commercial building

4. Community Benefits of Project:

a) Employment: (Estimated impact of project): Number of employees has increased from 9 to 12 and there are plans to add 2 more

b) Additional local taxes to be paid: current real estate taxes of approximately $2,000.00, sales tax of approximately $45,000.00

c) Other benefits: The larger facility will allow the business to expand and provide for additional employment

9. Describe the manner in which the issuance of the requested bond(s) will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

Sevan Ltd. had operated out of a leased facility on Tidewater Drive until August, 1980 when it was forced to relocate as a result of fire. The Company has been temporarily operating out of 3301 N. Military Highway since the fire. The Company would like to stay at this larger facility but only if it can purchase the facility and make substantial improvements. The new facility will allow the Company to expand its operations which will result in increased employment and increased sales all of which will benefit the State of Virginia and the City of Norfolk.

Signed: Charles T. Parker

Applicant: CHARLES T. PARKER

By: ______________________ (Title)

Date: November 13, 1980

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. Applicant Information:

a) Name of applicant: Military Distributors of Virginia, Inc.

b) Business address: 3587 Argonne Avenue
Norfolk, Virginia 23509

c) Legal entity: (individual, partnership or corporation): Virginia Corporation

d) Name and title of official representative: George T. Stagg, President

e) Business telephone: Company 855-0114 Representative Same

f) Principal business of applicant: Storage, handling and distribution of a general line of groceries to U. S. Military Installations.

2. Bond Issue Information:

a) Amount of bond issue: $ 1,000,000.00

b) Maturity: Twenty-five (25) Years

c) Proposed purchaser of bond(s): First & Merchants National Bank is attempting placement with third party.

d) Name of purchaser contact: John W. Payne, III

e) Has commitment been issued? No [illegible]

3. Project Information:

a) Location of improvements: 3587 Argonne Avenue, Norfolk, Virginia 23509

b) Brief narrative description of improvements to be financed: Purchase of a 3 acre tract zoned M-3 at a cost of $508,000. Existing improvements include a dry storage warehouse 29,544 sq. ft., cold storage facilities of 7,235 sq. ft. and office space of 3,671 sq. ft. Secondly, the construction of additional cold storage facilities of 14,396 sq. ft. adjacent to the northern exposure of present structur

4. Community Benefits of Project:

a) Employment: (Estimated impact of project): Necessary for retention and increase of approximately 67 Jobs.

b) Additional local taxes to be paid: Approximate 100% increase from $5,271 to $10,400

c) Other benefits: Increased use of Norfolk Port facilities.

Services provide vital logistic support for the supply of goods to local military installations as well as those overseas.

9. Describe the manner in which the issuance of the requested bond(s) will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

We request your assistance in arranging financing for the purchase and construction of this project for $1,000,000.00. The company has carefully considered its ability to purchase and construct the new premises and has concluded that without the assistanc of the Authority and the issuance of its revenue bonds, the feasibility of such purchas and construction is very doubtful. Military Distributors of Virginia, Inc. would like very much to keep its facilities in the City of Norfolk; however, our present facilitie are inadequate and cramped. In order for the company to continue to grow, it must expand its facilities either in Norfolk or some other jurisdiction. We consider Norfolk the ideal location for our company because of the nature of our business and the customers we serve. The Authority's consideration will be appreciated.

Signed: George T. Stagg
Applicant: MIL.TARY. DIST. OF VA. INC.
By: George T. Stagg Pres.
(Title)
Date: June 12, 1980

Industrial Development Authority of the City of Norfolk

P.O. Box 1219
Norfolk, Virginia 23501
804-441-2941

APPLICATION

1. Applicant Information:
   a) Name of applicant: THE BUTE COMPANY
   b) Business address: 229 West Bute Street
      Norfolk, Virginia 23510
   c) Legal entity: (individual, partnership or corporation): General Partnership
   d) Name and title of official representative: John B. McGaughy, Managing Partner
   e) Business telephone: Company c/o McGaughy, Marshall, McMillan Representative 623-164
      [illegible]
   f) Principal business of applicant: Lessor of Real Estate
2. Bond Issue Information:
   a) Amount of bond issue: $ 900,000
   b) Maturity: Twenty years Years
   c) Proposed purchaser of bond(s): United Virginia Bank/Seaboard National Bank
   d) Name of purchaser contact: Arthur Lyles
   e) Has commitment been issued? No — If so, please attach a copy
3. Project Information:
   a) Location of improvements: The Wainwright Building
      229 West Bute Street
      Norfolk, Virginia 23510
   b) Brief narrative description of improvements to be financed: Renovation of lobby and entrances, replacement of elevators, cleaning of exterior, replacement of exterior windows, renovations to plumbing and heating equipment.
4. Community Benefits of Project:
   a) Employment: (Estimated impact of project): SEE ATTACHED
   b) Additional local taxes to be paid: SEE ATTACHED
   c) Other benefits: SEE ATTACHED

4. (A) The Bute Company, after acquiring the Wainwright Building, will have a payroll of 24 employées. During the renovation period, additional employment should occur and also other local construction companies should benefit. At completion of the renovations, it is anticipated that four employees will be released as a result of the installation of fully automatic elevators.

(B) It is anticipated that the City of Norfolk should receive additional real estate taxes of $10,000 annually as a result of the increased value of the building, and the state and city receiving a sales tax of $20,000 over 1981 and 1982 as a result of purchase of construction products.

(C) These anticipated renovations will return the Wainwright Building to one of the finest office buildings in downtown Norfolk. The renovations will improve greatly its outside appearance as a result of a complete cleaning of the exterior brick, screening on equipment, and improvements to the front and rear entrances. The Bute Company anticipates replacing its present coal boiler system with a modern clean gas fired boiler which will result in less air pollution around the building. The completed project should compliment the Norfolk Redevelopment and Housing Authority Downtown West (Freemason Harbor) renovation area and will be a catalyst in encouraging other property owners to perform similar improvements to their real estate in this historic area.

9. Describe the manner in which the issuance of the requested bond(s) will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

The issuance of bonds are for the renovation of The Wainwright Building an old historic building, in downtown Norfolk, Virginia which will improve its interior and exterior appearance, as well as its operational efficiency. The renovation project will compliment the Norfolk's Redevelopment and Housing Authority Downtown West (Freemason Harbor) renovation area. This renovation project, however, will not be economically feasible unless industrial revenue bonds are obtained.

Signed:

Applicant: The Bute Company

By: Managing Partner (Title)

Date: August 20, 1980

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. Applicant Information:

a) Name of applicant: Groves-Faison Associates

b) Business address: 3801 East Princess Anne Road
Norfolk, Virginia

c) Legal entity: (individual, partnership or corporation): Partnership

d) Name and title of official representative: Ralph Groves, Partner

e) Business telephone: Company 857-0148 Representative

f) Principal business of applicant: Real estate partnership

2. Bond Issue Information:

a) Amount of bond issue: $ 215,000 (estimated)

b) Maturity: 10-20 Years

c) Proposed purchaser of bond(s): United Virginia Bank

d) Name of purchaser contact: George E. Gowen, Vice-President

e) Has commitment been issued? No If so, please attach a copy

3. Project Information:

a) Location of improvements: 2207 Llewellyn Avenue, Norfolk, Virginia
(former Sealtest Dairy Plant)

b) Brief narrative description of improvements to be financed: Former cold storage/dairy processing plant consisting of approximately 45,000 square feet of improvements on 1.3 acres (see attached plats)

4. Community Benefits of Project:

a) Employment: (Estimated impact of project): 20 new employees

b) Additional local taxes to be paid: real estate taxes on $215,000 real property

c) Other benefits: City License tax increase

9. **Describe the manner in which the issuance of the requested bond(s)** will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

Groves-Faison Military Sales Company is currently leasing space in Norfolk and needs to acquire a facility to continue and expand its business in Norfolk.

Signed: Partner

Applicant: Groves-Faison Associates

By: (Title)

Date: May 19, 1980

Industrial Development Authority of the City of Norfolk

P.O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
   - a) Name of applicant: Codi Associates
   - b) Business address: 1112 Kingwood Ave.
     Norfolk, VA 23502
   - c) Legal entity: (individual, partnership or corporation): Partnership
   - d) Name and title of official representative: Arthur Diamonstein/General Partner
   - e) Business telephone: Company 804-855-7222 Representative
   - f) Principal business of applicant: Real Estate & Equipment Rental
2. **Bond Issue Information:**
   - a) Amount of bond issue: $400,000
   - b) Maturity: 10 years Years
   - c) Proposed purchaser of bond(s): United Virginia Bank
   - d) Name of purchaser contact: David Clark IV
   - e) Has commitment been issued? Yes If so, please attach a copy
3. **Project Information:**
   - a) Location of improvements: 1112 Kingwood Ave.
   - b) Brief narrative description of improvements to be financed: IBM Series 34 Computer
     Conveyor System, Mfg. Equipment
     Vehicles, Building Renovation.
4. **Community Benefits of Project:**
   - a) Employment: (Estimated impact of project): Eventually as many as 16 additional jobs.
   - b) Additional local taxes to be paid: Additional personal property and real estate taxes.
   - c) Other benefits: Without such funding P.B.C. might be forced to add facilities in other areas.

9. Describe the manner in which the issuance of the requested bond(s) will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

Codi Associates is the primary lessor of Paramount Bedding Corp., a strong regional bedding manufacturer addressing the middle to upper price levels of bedding products. There is an equal market existing in less expensive bedding products into which Paramount Bedding Corp. desires to expand. Paramount Bedding Corp. currently realizes approximately 40% of its volums from Richmond and areas west and north of it. Consequently, if the bonds were not issued, it would make proper business sense to look for expansion facilities nearer the market place which is the target of the expansion. On the other hand, issuance of the bond will permit the modernization of current facilities and enable Paramount Bedding Corp. to make this expansion and create this new product line directly from its present location. The latter alternative obviously is the economically and desirable one.

Signed:

Applicant: Codi Associates

By: Arthur Diamonstein/General Partner
(Title)

Date: January 14, 1981

IDA Signed Copy

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. Applicant Information:

a) Name of applicant: Freemason Plaza, Ltd.

b) Business address: c/o Willcox, Savage, Lawrence, Dickson & Spindle, P.
1800 Virginia National Bank Building
Norfolk, Virginia 23510

c) Legal entity: (individual, partnership or corporation): Limited Partnership

d) Name and title of official representative: Mr. Arnold Orleans, General Partner

e) Business telephone: xxxxxx 627-0611) PLease ask for
Ron Donn, Esq. xxxxxxxx

f) Principal business of applicant: Operation of hotel

2. Bond Issue Information:

a) Amount of bond issue: $ approximately $3,500,000.00

b) Maturity: formal terms of bonds not yet negotiated with Years

c) Proposed purchaser of bond(s): United Virginia Bank

d) Name of purchaser contact: Thomas V. Rueger

e) Has commitment been issued? No If so, please attach a copy.

3. Project Information:

a) Location of improvements: Old Commodore Maury Hotel located at the corner of Granby Street and Freemason Street in Norfolk, Va.

b) Brief narrative description of improvements to be financed: Improvements -- complete renovation of rooms and public spaces and equipping of old hotel

4. Community Benefits of Project:

a) Employment: (Estimated impact of project): (a) renovated hotel will employ approximately 65 or more persons -- present hotel employs few persons.

b) Additional local taxes to be paid: will increase real estate and business income taxes

c) Other benefits: Complete renovation of hotel will greatly contribute to revitalization of Granby Mall and downtown Norfolk areas.

9. **Describe the manner in which the issuance of the requested bond(s)** will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

The applicant could not afford to undertake the planned renovations to the old Commodore Maury hotel without the issuance of industrial revenue bonds and consequently, would not initiate and locate a new hotel business in Norfolk without this financial assistance. The applicant feels that this new business venture will contribute towards the revitalization of the downtown Norfolk area and its general economy.

Signed: Ronald P. Sonn, attorney

Applicant: FREEMASON PLAZA, LTD.

By: ____________________ (Title)

Date: ____________________

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**

a) Name of applicant: Richard E. Beck and Joyce S. Beck or Eastern Roofing Corporation or assigns

b) Business address: 2704 Arkansas Avenue
Norfolk, Virginia 23513

c) Legal entity: (individual, partnership or corporation): individuals or corporation

d) Name and title of official representative: Richard E. Beck, chairman of the board

e) Business telephone: Company 855-3103 Representative

f) Principal business of applicant roofing and sheet metal contracting

2. **Bond Issue Information:**

a) Amount of bond issue $ 300,000

b) Maturity 20 Years

c) Proposed purchaser of bond(s) United Virginia Bank

d) Name of purchaser contact G. Wilson Thomas II

e) Has commitment been issued? no If so please attach a copy.

3. **Project Information:**

a) Location of improvements St. Julian Avenue at Maltby Avenue

b) Brief narrative description of improvements to be financed Corporate Headquarters
10,000 sq. ft. of warehouse
8,500 sq. ft. of office and shops

4. **Community Benefits of Project:**

a) Employment: (Estimated impact of project) 150-200

b) Additional local taxes to be paid

c) Other benefits

3. **Describe the manner in which the issuance of the requested bond(s) will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.**

Eastern Roofing Corporation has determined that it must expand its current operations in order to keep pace with its customers' needs. The corporation would very much like to remain in and construct its proposed new facility in the City of Norfolk but requires the assistance of the Industrial Development Authority of the City of Norfolk for financing. If such financing is not available, it will not be economically feasible for applicant to remain in Norfolk and it will be forced to move its operations to property currently under option in Hampton Industrial Park.

Signed:

Applicant: Eastern Roofing Corporation

By: Richard E. Beck Chairman of the Board (Title)

Date: 3-19-81

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
    - a) Name of applicant: Commonwealth Foods, Inc.
    - b) Business address: 3487 Inventors Road
      Norfolk, Virginia 23502
    - c) Legal entity: (individual, partnership or corporation): Corporation
    - d) Name and title of official representative: Eugene Walters, President
    - e) Business telephone: Company 804-853-7461 804-481-2483 Representative
    - f) Principal business of applicant Retail Supermarket
2. **Bond Issue Information:**
    - a) Amount of bond issue $ 3,000,000
    - b) Maturity Twenty (20) Years
    - c) Proposed purchaser of bond(s) To Be Negotiated
    - d) Name of purchaser contact To Be Negotiated
    - e) Has commitment been issued? No If so please attach a copy
3. **Project Information:**
    - a) Location of improvements Formerly Robert Hall Village located at intersection of Tidewater Drive & Little Creek Road
    - b) Brief narrative description of improvements to be financed
        1. New Equipment for retail Combination Store
        2. Remodeling interior of existing building
4. **Community Benefits of Project:**
    - a) Employment: (Estimated impact of project) 500 New Employees
    - b) Additional local taxes to be paid $250,000 Sales Tax Revenue; $37,000 Utilities Taxes; $250,000 for school improvements; $25,000 R/E Taxes
    - c) Other benefits (See Above)

9. **Describe the manner in which the issuance of the requested bond(s)** will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

Due to the high cost of interest, an Industrial Revenue Bond is the only way that any business can expand to provide additional employment and local taxes to the community.

Signed: Commonwealth Foods, Inc.
Applicant: Commonwealth Foods, Inc.
By: Eugene Walter President
(Title)
Date: December 10, 1980

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
   a) Name of applicant: Oil Equipment Properties
   b) Business address: P. O. Box 12417
   5622 Virginia Beach Boulevard
   Norfolk, Virginia 23502
   c) Legal entity: (individual, partnership or corporation): Virginia general partnership
   d) Name and title of official representative: J. H. Prentiss, Jr., Partner
   e) Business telephone: Company 461-2274 Representative
   f) Principal business of applicant sale and service of oil equipment
2. **Bond Issue Information:**
   a) Amount of bond issue $ 1,000,000
   b) Maturity - Years
   c) Proposed purchaser of bond(s) -
   d) Name of purchaser contact -
   e) Has commitment been issued? - If so, please attach a copy
3. **Project Information:**
   a) Location of improvements Village Avenue and Pineridge Road
   b) Brief narrative description of improvements to be financed headquarters office, warehouse and sales distribution center in Norfolk Industrial Park
4. **Community Benefits of Project:**
   a) Employment: (Estimated impact of project) 15-20 new employees
   b) Additional local taxes to be paid sales taxes and real estate taxes
   c) Other benefits

f. Describe the manner in which the issuance of the requested bond(s) will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

Oil Equipment Properties will lease the facility to Jones & Frank Oil Equipment Corporation. The new facility will permit the corporation to not only remain in Norfolk but to establish its headquarters here as well as a warehouse and sales distribution center. Without Industrial Development Bond financing, this project would not be financially feasible.

Signed:

Applicant: Oil Equipment Properties

By: J. H. Prentiss, Jr., Partner (Title)

Date: December 10, 1980

Industrial Development Authority of the City of Norfolk

P.O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
   - a) Name of applicant: Ecolochem, Inc.
   - b) Business address: P. O. Box 12775
     4545 Patent Road
     Norfolk, Virginia 23502
   - c) Legal entity: (individual, partnership or corporation): Corporation
   - d) Name and title of official representative: Richard C. Dickerson, Exec. Vice President
   - e) Business telephone: Company 855-9000 Representative 855-9000
   - f) Principal business of applicant Water Treatment
2. **Bond Issue Information:**
   - a) Amount of bond issue $ 1,750,000
   - b) Maturity Five (5) Years
   - c) Proposed purchaser of bond(s) First & Merchants National Bank
   - d) Name of purchaser contact Robert J. Keogh
   - e) Has commitment been issued? Copy Attached If so, please attach a copy
3. **Project Information:**
   - a) Location of improvements 4545 Patent Road
     Norfolk, Virginia.Mobile Trailers
   - b) Brief narrative description of improvements to be financed Mobile Deionization Units for On-Site Water Treatment
4. **Community Benefits of Project:**
   - a) Employment: (Estimated impact of project) 34 Individuals
   - b) Additional local taxes to be paid Personal Property, License Fees
   - c) Other benefits

9. **Describe the manner in which the issuance of the requested bond(s)** will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

Applicants manufacturing/regeneration facility located in Norfolk serves basically the entire East Coast. Construction of the new self-contained, mobile, large deionization units will result in increased employment, increased efficiency, and permit an expansion of applicant's existing business capability which will directly benefit Norfolk, Virginia, the location of applicant's corporate headquarters and its largest manufacturing facility.

Signed:
Applicant: Ecolochem, Inc.
By: Richard C. Dickerson Ex Vice Pres (Title)
Date: 4-17-81

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
   - a) Name of applicant: Gerald M. and Ruth H. Zeno or Virginia Dental Laboratories, Inc.
   - b) Business address: 130 West York Street
     Norfolk, Virginia 23510
   - c) Legal entity: (individual, partnership or corporation): Corporation
   - d) Name and title of official representative: Gerald M. Zeno, Secretary-Treasurer
   - e) Business telephone: Company 622-4614 Representative
   - f) Principal business of applicant: Dental Prosthetics to the Profession Only
2. **Bond Issue Information:**
   - a) Amount of bond issue: $ 200,000.00
   - b) Maturity: 15-20 Years
   - c) Proposed purchaser of bond(s): not known
   - d) Name of purchaser contact:
   - e) Has commitment been issued? No If so, please attach a copy
3. **Project Information:**
   - a) Location of improvements: 130 West York Street, Norfolk, Virginia
   - b) Brief narrative description of improvements to be financed: To purchase building now rented, adding parcel to north of property for expansion of facility, do necessary repairs and renovation to present structure.
4. **Community Benefits of Project:**
   - a) Employment: (Estimated impact of project): Possible increase of 3 to 5 persons
   - b) Additional local taxes to be paid:
   - c) Other benefits:

9. **Describe the manner in which the issuance of the requested bond(s)** will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

Our company has been established in Norfolk for 48 years, and has occupied the present facilities for 33 years. Though the center of pupulation and our dentist customers seem to be moving south and east, we would prefer to modernize, expand and improve our present facility in Norfolk.

Signed: Gerald M. Zeno

Applicant: Gerald M. and Ruth H. Zeno or Virginia Dental Laboratories, Inc.

By: Gerald M. Zeno Secretary-Treasurer (Title)

Date: September 16, 1980

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
   - a) Name of applicant: GEORGE STENKE and JOSEPHINE STENKE
   - b) Business address: 1526 Early Street
     Norfolk, Virginia
   - c) Legal entity: (individual, partnership or corporation): Individuals
   - d) Name and title of official representative: George Stenke
   - e) Business telephone: Company 855-0991 Representative
   - f) Principal business of applicant: Fence Company/Moving Company - but this application relates to warehouse facilities
2. **Bond Issue Information:**
   - a) Amount of bond issue: $ 600,000.00
   - b) Maturity: 10 - 15 Years
   - c) Proposed purchaser of bond(s): Virginia National Bank
   - d) Name of purchaser contact: Mrs. Elspeth S. Campbell
   - e) Has commitment been issued? No If so, please attach a copy
3. **Project Information:**
   - a) Location of improvements: West side of Harmony Road, approximately 531 feet south of Quill Road
   - b) Brief narrative description of improvements to be financed: Warehouse building to be constructed and to be divided into approximately 14 sections for lease. Total size 26,010 square feet.
     Note: The "Proposed mini-storage warehouses" shown on the Site Plan are not to be included in the bond transaction.
4. **Community Benefits of Project:**
   - a) Employment: (Estimated impact of project): 56
   - b) Additional local taxes to be paid: $3,000.00
   - c) Other benefits: Will provide small businesses that have growth potential space in which to get started.

9. **Describe the manner in which the issuance of the requested bond(s)** will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

The proposed business is separate from others owned and operated by applicant. Coventional financing at a rate which would make the project feasible in Virginia and in Norfolk is not available. Issuance of the requested bond(s) will allow the business to be located in Norfolk.

Signed: George Stenke
George Stenke
Applicant: Josephine A Stenke
Josephine Stenke
By: ____________________ (Title)
Date: December 10, 1980

ATTORNEY:

Richard D. Guy
Guy, Cromwell, Betz & Lustig
Pembroke Office Park
Pembroke One Building - Suite 525
Virginia Beach, Virginia 23462
Telephone No. 499-8971

Industrial Development Authority of the City of Norfolk

P.O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. Applicant Information:

a) Name of applicant: Ralston Purina Company

b) Business address: Checkerboard Square
St. Louis, Missouri 63188

c) Legal entity: (individual, partnership or corporation): Corporation

d) Name and title of official representative: Ron Winney (Finance), Harry Palmer (Project Real Estate Manager)

e) Business telephone: Company (314) 982-2544 Representative (804) 466-8440

f) Principal business of applicant: Animal feeds, tuna processing and restaurant development.

2. Bond Issue Information:

a) Amount of bond issue: $ 1,000,000.00 (One million dollars)

b) Maturity: 20 to 25 Years

c) Proposed purchaser of bond(s): Thornton, Farish & Gauntt, Inc.

d) Name of purchaser contact: Susan M. Alley (205) 265-0221

e) Has commitment been issued? Yes Copy attached. If so, please attach a copy

3. Project Information:

a) Location of improvements: Best Square, North Military Highway

b) Brief narrative description of improvements to be financed: 11,500 square foot restaurant building

4. Community Benefits of Project:

a) Employment: (Estimated impact of project): 4 skilled and 100 unskilled employees

b) Additional local taxes to be paid: $7,000 Personal Property Tax, $13,000 Real Estate Tax, $67,100 Restaurant Tax

c) Other benefits: Offers an attractive dining facility to local residents and out-of-town visitors.

9. **Describe the manner in which the issuance of the requested bond(s)** will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

This Bond issue enables Ralston Purina Company to economically justify this location within the city limits of Norfolk. Ralston Purina Company is continually looking at various locations throughout the United States. Industrial Revenue Bonds financing is a major factor in selecting this site for one of our new restaurants. Passing of the inducement letter will enable construction to begin immediately.

Signed: Harry Palmer Harry Palmer

Applicant: Ralston Purina Company

By: Regional Real Estate Manager, Eastern Region (Title)

Date: August 19, 1980

1541

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
   - a) Name of applicant: Ulysses T. Brown and Joseph Dandell
   - b) Business address: 7522 Tidewater Drive, Norfolk, Va.
   - c) Legal entity: (individual, partnership or corporation): Partnership
   - d) Name and title of official representative: Vincent Mastracca, Jr. - Lawyer Canoles, Mastracca, Matrone Barr & Russell
     Company Representative
   - e) Business telephone: 623-9990
   - f) Principal business of applicant: 20 years-service station, 4 years-Auto Painting
2. **Bond Issue Information:**
   - a) Amount of bond issue: $ 450,000
   - b) Maturity: 12 years (negotiable) Years
   - c) Proposed purchaser of bond(s) unsecured 2/2/81 ~~Ulysses T. Brown and Joseph Dandell~~
   - d) Name of purchaser contact: Ulysses T. Brown, 703-451-1644
   - e) Has commitment been issued? No
     If so, please attach a copy
3. **Project Information:**
   - a) Location of improvements: 7522 Tidewater Drive, Norfolk, Va.
   - b) Brief narrative description of improvements to be financed: Purchase of Property-Minor modification to accomodate Maaco-New well for car wash-New pumps and Kiosk for gas facilities
4. **Community Benefits of Project:**
   - a) Employment: (Estimated impact of project): 23 new employees-first year
   - b) Additional local taxes to be paid: Approximately $14,162
   - c) Other benefits: 30 employees after first year
     annual payroll=$319,636

9. **Describe the manner in which the issuance of the requested bond(s)** will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

Issuance of requested bonds is for the purpose of moving Maaco Auto Painting from Virginia Beach into Norfolk, and to reopen closed car wash and gasoline facilities at 7522 Tidewater Drive.

Signed:

Applicant: Ulysses T. Brown and Joseph Dowdell

By: Vincent J. Mastracco (Title)

Date: January 14, 1981

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
   - a) Name of applicant: MEDICAL TOWER ASSOCIATES
   - b) Business address: 406 Medical Tower
     Norfolk, Virginia 23507
   - c) Legal entity: (individual, partnership or corporation): Partnership
   - d) Name and title of official representative: David M. Pariser, M.D., General Partner
   - e) Business telephone: Company (804) 622-6315 Representative
   - f) Principal business of applicant: Leasing of medical and dental offices
2. **Bond Issue Information:**
   - a) Amount of bond issue: $ 3,800,000
   - b) Maturity: 25 (estimated) Years
   - c) Proposed purchaser of bond(s): Commercial bank or insurance company
   - d) Name of purchaser contact: Atlantic Mtg. & Inv. Co. of Va. (Thomas J. Mueller, 1-288-6700); Davenport & Co. of Va., Inc. (T.N.P. Johnson, 1-780-2000)
   - e) Has commitment been issued? no If so, please attach a copy.
3. **Project Information:**
   - a) Location of improvements: Medical Tower, Gresham Drive, Norfolk, VA
   - b) Brief narrative description of improvements to be financed: Acquisition and renovation of Medical Tower Office building.
4. **Community Benefits of Project:**
   - a) Employment: (Estimated impact of project)
   - b) Additional local taxes to be paid: Real estate taxes are estimated to be $59,000 (annual) based on an estimated assessment of $4,500,000.
   - c) Other benefits

9. **Describe the manner in which the issuance of the requested bond(s)** will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

Physicians and dentists practicing in the Norfolk General Hospital medical complex require space for medical offices and treatment rooms in close proximity to the institutions they serve. Located either directly adjacent to or within a short distance of the Medical Tower, in this regard, is Norfolk General Hospital, Eastern Virginia Medical School, Children's Hospital of the King's Daughters, Norfolk Public Health Center, Community Mental Health Center, Tidewater Rehabilitation Institute, the American Red Cross, and other medically oriented buildings. The acquisition and renovation of the Medical Tower is essential in order to induce physicians and dentists to locate or remain in the medical complex. *

Signed:

Applicant: Medical Tower Associates

By:
David M. Pariser, M.D., General Partner

Date: October 14, 1980

*Should the Medical Tower office building be purchased by outside investors and devoted to uses other than the leasing of space for medical offices and treatment rooms, the private medical community would be dispersed to areas more distant from the medical center complex, thus reducing the present high level of medical care given patients at these institutions. In addition, the continued availability of medical space in such close proximity to the medical complex provides an inducement to new physician and dental surgeon groups to locate in Norfolk and to become a part of an increasingly specialized medical center. With respect to the future needs of the growing private medical community, the real property surrounding the Medical Tower, approximately 6-1/3 acres, is adequate to provide for a multi-story parking facility and an additional office building.

1545

Industrial Development Authority of the City of Norfolk

P.O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**

   a) Name of applicant: Donning Properties

   b) Business address: 5041 Admiral Wright Road
   Virginia Beach, VA 23462

   c) Legal entity: (individual, partnership or corporation): Virginia general partnership

   d) Name and title of official representative: Stanley G. Barr, Jr.

   e) Business telephone: 499-0589 Company 623-9990 Representative

   f) Principal business of applicant: real estate ownership

2. **Bond Issue Information:**

   a) Amount of bond issue: $ 194,000

   b) Maturity: Thirty Years

   c) Proposed purchaser of bond(s): J. W. Creech

   d) Name of purchaser contact: J. W. Creech

   e) Has commitment been issued? Yes If so, please attach a copy.

3. **Project Information:**

   a) Location of improvements: 5659 & 5661 Virginia Beach Blvd.

   b) Brief narrative description of improvements to be financed: purchase of one-story brick building of 4,600 square feet, situated on site approx. 90 x 300 ft., fronting on Virginia Beach Boulevard

4. **Community Benefits of Project:**

   a) Employment: (Estimated impact of project): Building will house Donning Publishing Co. and its affiliate businesses, employing approx. 30 people, presently doing business in Va. Beach

   b) Additional local taxes to be paid: increase in valuation of building will cause an increase in the present real estate taxes

   c) Other benefits:

9. **Describe the manner in which the issuance of the requested bond(s) will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.**

The buyer would be unable to obtain financing as desirable from conventional sources, and the seller would be unwilling to sell on any terms other then tax-free financing.

Signed:
Applicant: Donning Properties
By: General Partner
(Title)
Date: May 20, 1981

Industrial Development Authority of the City of Norfolk

P.O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
   - a) Name of applicant: Norfolk Food Factory Associates
   - b) Business address: 4505 Colley Avenue
     Norfolk, Virginia 23508
   - c) Legal entity: (individual, partnership or corporation): Partnership
   - d) Name and title of official representative: Alfred E. Abiouness
   - e) Business telephone: Company (804) 489-7040 Representative
   - f) Principal business of applicant: Growing Vegetables
2. **Bond Issue Information:**
   - a) Amount of bond issue: $ 1,700,000.00
   - b) Maturity: 20 Years
   - c) Proposed purchaser of bond(s): -------
   - d) Name of purchaser contact: -------
   - e) Has commitment been issued? No If so, please attach a copy
3. **Project Information:**
   - a) Location of improvements: East of Lance Rd. and North of Raby Rd.
   - b) Brief narrative description of improvements to be financed: 34 Hygroponic Greenhouses (30' X 124') plus an 8,000 Sq. Ft. Service Bldg. and Office
4. **Community Benefits of Project:**
   - a) Employment: (Estimated impact of project): 25 to 30 People @ Outset
   - b) Additional local taxes to be paid: $12,000 RE Tax Plus P.P. Tax
   - c) Other benefits: Plus Sales Taxes

9. **Describe the manner in which the issuance of the requested bond(s)** will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

The Limited Partnership (Norfolk Food Factory Assoc.) will have as the General Partner Agri-Group, Inc. Agri-Group, Inc. has the National and International distributorship for all Hygroponic, Inc. products, and they plan to locate their East Coast Distributorship in Norfolk and use this facility as their model for other super-market chains, as well as a training center for domestic and international managers. This will also be the Groups Research and Development Center.

Signed:

Applicant: NORFOLK FOOD FACTORY ASSOCIATES

By: Attorney-in-Fact (Title)

Date: December 10, 1980

1549

Industrial Development Authority of the City of Norfolk

P.O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
   - a) Name of applicant: V. L. & L. G. Reca
   - b) Business address: 161 Wellman Street
Norfolk, VA 23502
   - c) Legal entity: (individual, partnership or corporation): Individual
   - d) Name and title of official representative: V. L. Reca
   - e) Business telephone: Company Valjar Inc. 424-3322 Representative
   - f) Principal business of applicant President-Sole Stockholder Valjar Inc.
2. **Bond Issue Information:**
   - a) Amount of bond issue [illegible] $ 650,000.00
   - b) Maturity 15 yrs. Years
   - c) Proposed purchaser of bond(s) Bank of Virginia
   - d) Name of purchaser contact Scott Stolldorf
   - e) Has commitment been issued? No If so, please attach a copy
3. **Project Information:**
   - a) Location of improvements 1179 Lance Road, Norfolk, VA
   - b) Brief narrative description of improvements to be financed Offices, Repair Shop, Parts Sales Dept (Aprx 11,000 SF Bldg) Equipment Storage Yard, Underground Fuel Storage
4. **Community Benefits of Project:**
   - a) Employment: (Estimated impact of project) Aprx 12 Employees- $234,000.
   - b) Additional local taxes to be paid $8,450.00 year Real Estate, $1,500.00 Local Sales Tax
   - c) Other benefits Continued Location of Business in Norfolk

9. Describe the manner in which the issuance of the requested bond(s) will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

See Attached Sheet

Signed: Laura G. Reca

Applicant: V.L. & Laura G. Reca

By: V.L. & Laura G. Reca (Title)

Date: October 15, 1980

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
   - a) Name of applicant: Marine Hydraulics International, Inc. or affiliated company to be formed.
   - b) Business address: 3703 Cook Boulevard
     Chesapeake, Virginia 23323
   - c) Legal entity: (individual, partnership or corporation): Corporation
   - d) Name and title of official representative: Guy K. Tower, Canoles, Mastracco, Martone, Barr & Russell - 1530 Va. Natl. Bank Bldg. Norfolk, Virginia 23510
   - e) Business telephone: Company 487-8871 Representative 623-999
   - f) Principal business of applicant: Ship Repair
2. **Bond Issue Information:**
   - a) Amount of bond issue: $ 1,800,000
   - b) Maturity: Ten (10) Years
   - c) Proposed purchaser of bond(s): Equipment Unlimited, Inc.
   - d) Name of purchaser contact: Jessie Simpkins
   - e) Has commitment been issued? See contract attached. If so, please attach a copy.
3. **Project Information:**
   - a) Location of improvements: 800 East Indian River Road, Norfolk, VA
   - b) Brief narrative description of improvements to be financed: Acquisition approx. 23 acres, including bulkheading and one building (approx. 9000 sq. ft.)
4. **Community Benefits of Project:**
   - a) Employment: (Estimated impact of project): 70-150 employees over two year period.
   - b) Additional local taxes to be paid: $6,000.00
   - c) Other benefits:

9. Describe the manner in which the issuance of the requested bond(s) will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

Bonds will provide improved waterfront property which will allow Marine Hydraulics International, Inc. to expand its ship repair business by permitting work at its facility on both government and commercial vessels.

Signed

Applicant: Marine Hydraulics International, Inc.

By: Robert S. Walker, Chairman (Title)

Date: June 16, 1981

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
   - a) Name of applicant: CBA Properties
   - b) Business address: 703 Confederate Avenue
     Portsmouth, VA 23704
   - c) Legal entity: (individual, partnership or corporation): partnership (Virginia)
   - d) Name and title of official representative: Norman M. Goodloe, Jr.
   - e) Business telephone: Company 393-1061 Representative
   - f) Principal business of applicant: real estate investment
2. **Bond Issue Information:**
   - a) Amount of bond issue: $ 700,000.00
   - b) Maturity: Fifteen (15) Years
   - c) Proposed purchaser of bond(s): Central Fidelity Bank
   - d) Name of purchaser contact: Jeff Dykeman
   - e) Has commitment been issued? no — If so, please attach a copy
3. **Project Information:**
   - a) Location of improvements: Tidewater Drive
   - b) Brief narrative description of improvements to be financed: Land purchase, building and equipment for restaurant facility to be leased to Chesapeake Bay Associates, Inc. for use as a Bojangles franchise restaurant
4. **Community Benefits of Project:**
   - a) Employment: (Estimated impact of project): 40-50 - with annual payroll of $250,000.00
   - b) Additional local taxes to be paid: license tax, sales tax
   - c) Other benefits:

9. Describe the manner in which the issuance of the requested bond(s) will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

We cannot finance in existing market as it is not economically feasible without tax exempt financing.

Signed:

Applicant: CBA Properties

By: Norman E. Goodloe, Jr. Partner (Title)

Date: July 16, 1981

idustrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

. Applicant Information:

a) Name of applicant: Day Realty of South Carolina, Inc.

b) Business address: 145 King Street, Suite 227
Charleston, SC 29401

c) Legal entity: (individual, partnership or corporation): Corporation

d) Name and title of official representative: William D. Bowen, Executive Vice President

e) Business telephone: Company (803) 722-6608 Representative same

f) Principal business of applicant Motel/Hotel development and management

. Bond Issue Information:

a) Amount of bond issue $ not yet determinted

b) Maturity ______ Years

c) Proposed purchaser of bond(s) ______

d) Name of purchaser contact ______

e) Has commitment been issued? ______ If so please attach a copy

3. Project Information:

a) Location of improvements I-264 and Military Highway

b) Brief narrative description of improvements to be financed 5 story 150-180 unit hotel, 60 seat restau
and meeting rooms, and swimming pool. Bui
with reinforced concrete and concrete bloc
with brick veneer.

4. Community Benefits of Project:

a) Employment. (Estimated impact of project) Direct employment - 50 persons not includi
construction employees

b) Additional local taxes to be paid

c) Other benefits. 1) Indirect employment 2) the addition of
1 million dollars in revenue to the area
3) needed lodging and meeting rooms in th
[illegible]

Describe the manner in which the issuance of the requested bond(s) will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

Development of a Days Inn in the Norfolk area has been a primary objective for the last eighteen months. The unavailability of an adequate site, zoned with utilities, coupled with, if not dominated by, the scarcity of funding have been major deterents to our development program.

Past efforts have recently produced a site that meets the fundamental criteria for a motel, but the conventional financial market totally preclude development within the next 12 months.

We feel that the demand for quality, reasonably priced lodging justifies our development. At this time, only the issuance of the requested IDB's can provide us with the necessary funds.

Signed: William D. Bowen

Applicant: Day Realty of South Carolina, Inc.

By: William D. Bowen, Executive Vice President
(Title)

Date: April 11, 1980

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
   - a) Name of applicant: Sidney Popkin and Richard E. Popkin
   - b) Business address: 801 Front Street
     Norfolk, Virginia 23510
   - c) Legal entity: (individual, partnership or corporation): Individuals
   - d) Name and title of official representative: same
   - e) Business telephone: Company 622-5914 Representative
   - f) Principal business of applicant: Applicant will lease to Eastern Burlap & Trading Company for distribution of fiber glass, building materials and burlap containers.
2. **Bond Issue Information:**
   - a) Amount of bond issue: $ 250,000
   - b) Maturity: 15 - 20 years Years
   - c) Proposed purchaser of bond(s): Virginia National Bank
   - d) Name of purchaser contact: John Thomas
   - e) Has commitment been issued? no If so, please attach a copy
3. **Project Information:**
   - a) Location of improvements: 834 W. 25th Street
   - b) Brief narrative description of improvements to be financed: Purchase of existing warehouse and office to replace existing leased premises at 801 Front Street which have become inadequate.
4. **Community Benefits of Project:**
   - a) Employment: (Estimated impact of project): 1 or 2 additional employees
   - b) Additional local taxes to be paid: increased real estate taxes
   - c) Other benefits: increased business tax
     increased sales tax

9. Describe the manner in which the issuance of the requested bond(s) will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

Current leased premises are inadequate and the applicant must move. Conventional financing is prohibited and without tax exempt bond financing the purchase of the facility would not be feasible.

Signed: Sidney Popkin

Applicant:

By: (Title)

Date: August 19, 1981

Industrial Development Authority of the City of Norfolk

P.O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
    - a) Name of applicant: McGaughy,Marshall & McMillan
    - b) Business address: 229 West Bute Street, P.O. Box 269
      Norfolk, Virginia 23501
    - c) Legal entity: (individual, partnership or corporation): A Virginia Professional Corporation
    - d) Name and title of official representative: William Marshall Jr. Vice President/Secretary
    - e) Business telephone: Company 623-1641 Representative
    - f) Principal business of applicant: Architectural/Engineering Services
2. **Bond Issue Information:**
    - a) Amount of bond issue: $375,000
    - b) Maturity: Five (5) Years
    - c) Proposed purchaser of bond(s): To be negotiated.
    - d) Name of purchaser contact: N/A
    - e) Has commitment been issued? NO If so, please attach a copy
3. **Project Information:**
    - a) Location of improvements: 229 West Bute Street, Norfolk, Virginia
    - b) Brief narrative description of improvements to be financed
4. **Community Benefits of Project:**
    - a) Employment: (Estimated impact of project): Additional 6 employees will be required.
    - b) Additional local taxes to be paid: $14,000 (personal property taxes)
    - c) Other benefits: Increase in production capacity will provide growth, more employment and greater income broug into the City of Norfolk.

9. **Describe the manner in which the issuance of the requested bond(s)** will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

SEE ATTACHMENT G

Signed:

Applicant: McGaughy, Marshall & McMillan

By: William Marshall, Jr., Vice-Pres. & Sec.
(Title)

Date: March 25, 1981

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**

a) Name of applicant: H.M. WEBB & ASSOCIATES

b) Business address: 2715 Wyoming Avenue
Norfolk, Virginia 23513

c) Legal entity: (individual, partnership or corporation): a Virginia general partnership

d) Name and title of official representative: Howard M. Webb, Partner

e) Business telephone: Company 855-3006 Representative 623-3659

f) Principal business of applicant: Real estate holding partnership, primarily for the benefit of H.M. Webb & Associates, Inc., a Virginia corporation

2. **Bond Issue Information:**

a) Amount of bond issue: $ 300,000.00

b) Maturity: 20 year amortization schedule with a 10 Year balloon

c) Proposed purchaser of bond(s): Mr. Kenneth Perry

d) Name of purchaser contact: same

e) Has commitment been issued? No; verbal agreement being reduced to writing (If so, please attach a copy)

3. **Project Information:**

See Amended Resolution of Intent

a) Location of improvements: Norfolk Industrial Park

b) Brief narrative description of improvements to be financed: New building, approximately 13,000 square feet, offices and warehouse (see preliminary plans)

4. **Community Benefits of Project:**

a) Employment: (Estimated impact of project): 14 (current); 20-21 (within 3 years)

b) Additional local taxes to be paid: approximately $4,000 new real estate taxes;

c) Other benefits: plus additional machinery and other personal property taxes will likely accrue, as will additional payroll for City.

9. **Describe the manner in which the issuance of the requested bond(s)** will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

The Corporation must move into larger facilities due to overcrowding at its current location. It needs additional space for future expansion also. Unless it can obtain adequate financing for a new facility in Norfolk, it will be unable to remain here.

H.M. WEBB & ASSOCIATES, INC.

Signed: By Howard M. Webb President

Applicant: H.M. WEBB & ASSOCIATES

By: Howard M. Webb, Partner (Title)

Date: August 19, 1981

1563

Industrial Development Authority of the City of Norfolk

P.O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
   - a) Name of applicant: 21st - High Properties
   - b) Business address: 749 Boush Street
     Norfolk, Virginia 23510
   - c) Legal entity: (individual, partnership or corporation): a Virginia Limited Partnership to be formed
   - d) Name and title of official representative: Harvey Lindsay & Company, a Virginia corporati
     and Edward V. Power, General Partners
   - e) Business telephone: Company 627-0647 Representative
   - f) Principal business of applicant: Real estate development and investment
2. **Bond Issue Information:**
   - a) Amount of bond issue: $ 3,000,000
   - b) Maturity: not yet determined Years
   - c) Proposed purchaser of bond(s): CURRENTLY BEING NEGOTIATED WITH PROSPECTIVE
     NOT YET PURCHASERS
   - d) Name of purchaser contact
   - e) Has commitment been issued? IDENTIFIED
     If so, please attach a copy.
3. **Project Information:**
   - a) Location of improvements: 201 W. 21st Street, Norfolk, Virginia 23517
   - b) Brief narrative description of improvements to be financed: Acquisition of present Sears Roebuck & Co. building including parking lots and renovatior into retail commercial and manufacturing facilities.
4. **Community Benefits of Project:**
   - a) Employment: (Estimated impact of project): Approximately 200 people when project complet
   - b) Additional local taxes to be paid: Real estate and personal property taxes
   - c) Other benefits: Sales taxes

9. Describe the manner in which the issuance of the requested bond(s) will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

Without industrial revenue bond financing, this project would not be economically feasible. It is the intent of the Applicant to acquire the property so that it will remain in the stream of commerce. The Applicant recognizes that the property is pivotal in a vital section of the City and wishes to assure that it continues to be a generator of revenues, both direct and indirect.

Signed: Vincent J Mastracco Jr.

Applicant: 21st - High Properties

By:

Attorney (Title)

Date: July 15, 1981

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
   - a) Name of applicant: Shipshore Air Ferry Ltd.
   - b) Business address: #7 Selden Arcade
     Norfolk, Virginia 23510
   - c) Legal entity: (individual, partnership or corporation): Corporation
   - d) Name and title of official representative: Michael W. McCabe, President
   - e) Business telephone: Company 804-627-2094 804-627-0404 Representative
   - f) Principal business of applicant Helicopter Operator
2. **Bond Issue Information:**
   - a) Amount of bond issue $350,000.00
   - b) Maturity Seven (7) Years
   - c) Proposed purchaser of bond(s) United Virginia Bank
   - d) Name of purchaser contact David Clark, IV, Senior Vice President
   - e) Has commitment been issued? Yes If so please attach a copy
3. **Project Information:**
   - a) Location of improvements Norfolk International Airport
   - b) Brief narrative description of improvements to be financed Bell 260 B III helicopter
4. **Community Benefits of Project:**
   - a) Employment: (Estimated impact of project) 7-9 employees
   - b) Additional local taxes to be paid
   - c) Other benefits (1) Asst. maritime interest in congested shippin situation
     (2) Medical evacuation for ships and outlying areas.

9. **Describe the manner in which the issuance of the requested bond(s) will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.**

The purchase price of the Bell 206 B, JetRanger, III helicopter with accessories will be approximately $350,000. It is the considered judgment of the applicant that the purchase of such equipment through conventional financing would not be economically feasible, whereas financing through an industrial bond issue where the interest rate would be significantly lower would present a viable business endeavor. The City of Norfolk, and specifically the Norfolk International Airport, are well suited locations for the applicant to serve its maritime and other clientele. Accordingly, issuance of the requested bond by the Authority will be an inducement to the applicant to undertake the purchase of the helicopter and the location of its business in Norfolk.

Signed:

Applicant: Shipshore Air Ferry Ltd.

By: Sec./Treas
(Title)

Date: 3/11/81

Industrial Development Authority of the City of Norfolk

P.O. Box 1219
Norfolk, Virginia 23501
804-441-2941

APPLICATION

1. **Applicant Information:**
   - a) Name of applicant: Standard Office Supply, Inc.
   - b) Business address: 245 East Main Street
     Norfolk, Virginia 23514
   - c) Legal entity: (individual, partnership or corporation): Corporation
   - d) Name and title of official representative:
   - e) Business telephone: Company 622-7021 Representative
   - f) Principal business of applicant: Office supplies, furniture and design services
2. **Bond Issue Information:**
   - a) Amount of bond issue: $ maximum amount of $500,000.00
   - b) Maturity: not known Years
   - c) Proposed purchaser of bond(s): United Virginia Bank
   - d) Name of purchaser contact: William L. Sears
   - e) Has commitment been issued? No If so, please attach a copy.
3. **Project Information:**
   - a) Location of improvements: 1000 East City Hall Avenue
   - b) Brief narrative description of improvements to be financed: renovation and expansion of its distribution center to provide decorator and design showrooms, expanded corporate offices, an enclosed loading dock and other improvements
4. **Community Benefits of Project:**
   - a) Employment: (Estimated impact of project): 12-15 persons in six months, 15-20 persons after 18 months
   - b) Additional local taxes to be paid: increased real estate, wholesale and sales taxes
   - c) Other benefits:

9. **Describe the manner in which the issuance of the requested bond(s)** will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

Standard Office Supply is being evicted from its present location on Main Street and wishes to consolidate and expand its showroom and design decorator department with its warehouse facilities. An expanded distribution center is badly needed by the Company to service its various branch outlets. The issuance of the bonds will assure the Company's continued location in the City of Norfolk.

Signed:

Applicant: STANDARD OFFICE SUPPLY, INC.

By: JW Cotten J. W. Cotten Ch. of Board (Title)

Date: January 8, 1981

1569

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**

a) Name of applicant: Norfolk Surgical Associates

b) Business address: 844 Kempsville Road
Norfolk, Virginia 23502

c) Legal entity: (individual, partnership or corporation): a Virginia General Partnership

d) Name and title of official representative: Claiborne W. Fitchett and Jock R. Wheeler, General Partners

e) Business telephone: 461-2515 461-2515

f) Principal business of applicant: Operation of a medical building

2. **Bond Issue Information:**

a) Amount of bond issue $ 1,000,000.00

b) Maturity To be negotiated, probably 10 years Years

c) Proposed purchaser of bond(s) VNB Mortgage Corporation is attempting to place these bonds with one of its correspondent insurance companies.

d) Name of purchaser contact Mr. Ron Evans

e) Has commitment been issued? No If so, please attach a copy.

3. **Project Information:**

a) Location of improvements Located at corner of Brambleton Avenue and Duke Street in Norfolk, Virginia

b) Brief narrative description of improvements to be financed 1 story medical practice facility

4. **Community Benefits of Project:**

a) Employment: (Estimated impact of project) No substantial impact on employment -- 3 - 4 additional employees

b) Additional local taxes to be paid Substantial increase in real estate taxes -- no real estate taxes are currently being paid on this property.

c) Other benefits Will provide additional modern medical facilities for the downtown Norfolk area.

9. **Describe the manner in which the issuance of the requested bond(s)** will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

The Applicant could not afford to undertake the construction of the planned medical office building without the financial assistance offered by industrial development revenue bonds. The Applicant feels that this new business venture will add to Norfolk's tax base, will provide additional medical facilities of quality in the downtown area dn will contribute to the revitalization of that area and its general economy.

Signed: Jack R

Applicant: NORFOLK SURGICAL ASSOCIATES

By: General Partner (Title)

Date: May 7, 1981

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. Applicant Information:

a) Name of applicant: Redgate Medical Associates (See Exhibit A)

b) Business address: Suite 1
935 Redgate Avenue, Norfolk, VA

c) Legal entity: (individual, partnership or corporation): Partnership

d) Name and title of official representative: Dr. Arthur Kaplan and Jack Barr

e) Business telephone: Company 623-7878 Representative

f) Principal business of applicant: to construct and lease the Project

2. Bond Issue Information:

a) Amount of bond issue: $ 1,000,000

b) Maturity: unknown Years

c) Proposed purchaser of bond(s): Heritage Bank and Trust Company

d) Name of purchaser contact: Bernard Mathews 461-1976

e) Has commitment been issued? No — If so, please attach a copy

3. Project Information:

a) Location of improvements: s/w corner Redgate Avenue and Hampton Blvd.

b) Brief narrative description of improvements to be financed: 12,000 - 16,000 sq. ft. 2-story medical office building (the "Project")

4. Community Benefits of Project:

a) Employment: (Estimated impact of project): 12 physicians 23 support personnel

b) Additional local taxes to be paid: real estate, personal property and business license

c) Other benefits: See Exhibit B

9. **Describe the manner in which the issuance of the requested bond(s)** will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

Without the lower interest rate available through the use of industrial development revenue bonds, the Project would not be economically feasible in the current market. Accordingly, but for the issuance of the requested bonds, the Project would not be constructed or the construction thereof would be postponed indefinitely.

Signed:

Applicant: Redgate Medical Associates

By: Arthur S. Kaplan, M. D. (Title)

Date: June 11, 1981

Industrial Development Authority of the City of Norfolk

P. O. Box 1219
Norfolk, Virginia 23501
804—441-2941

APPLICATION

1. **Applicant Information:**
   - a) Name of applicant: Leonard A. Swann, Jr. or an assigned corporation
   - b) Business address: 130 Presidential Boulevard
     Bala Cynwyd, Pennsylvania 19004
   - c) Legal entity: (individual, partnership or corporation): Individual unless assigned
   - d) Name and title of official representative: John J. Tyrrell, Vice-President Engineering & Planning
   - e) Business telephone: Company (215) 649-7000 Representative
   - f) Principal business of applicant Investor and Publisher
2. **Bond Issue Information:**
   - a) Amount of bond issue $1,000,000
   - b) Maturity 20 years Years
   - c) Proposed purchaser of bond(s) United Virginia Bank
   - d) Name of purchaser contact Arthur D. Liles
   - e) Has commitment been issued? Yes If so please attach a copy
     Contact: Mr. Liles
3. **Project Information:**
   - a) Location of improvements 117-119 College Place
     Within the Downtown West Conservation District
   - b) Brief narrative description of improvements to be financed rehabilitation of building in central City of Norfolk as corporate headquarters of wholely owned publishing subsidiaries of the applicant including improvements, equipment and furniture.
4. **Community Benefits of Project:**
   - a) Employment: (Estimated impact of project) 40 - the majority of whom are professionals
   - b) Additional local taxes to be paid real estate and personal property
   - c) Other benefits rehabilitation of deteriorated building
     generation of business and employment in the central City.

9. Describe the manner in which the issuance of the requested bond(s) will be an inducement to the applicant to locate or continue all or part of its business in the State of Virginia and, particularly, in the City of Norfolk.

An inducement in the form of industrial revenue bonds is required for these publishing subsidiaries to locate in the City of Norfolk. If the requested bonds are not available or committed to this project, these subsidiaries will locate in another Tidewater city where industrial revenue bonds are available and committed.

Signed: J.P.C. Hanbury
Applicant: Leonard A. [illegible], Jr.
By: J. P. C. Hanbury, Architect (Title)
Date: 17 September 1980

Mr. **Anthony**. Before I do close, a final question.

Have you found that the issuance of the IRB's has hurt the regular bond market for other uses such as schools, fire or hospitals in your community?

Mr. **Thomas**. Well, the regular bond market is very tough.

In my opinion, it is tough because of the general high level of interest rates. We are looking at about 12 percent, I guess, triple A rating. Of course, that runs our costs up.

We are delaying through short-term bonds, we have authorized an issue fo $75 million in Norfolk, which we are holding back on until interest rates hopefully come down some.

The long term, I think the whole long-term market, whether it is mortgages or whatever, is just very high, it is just too high to support the kind of an economic activity and the kid of housing activity that we need to have.

Mr. **Anthony**. So the problem is not the IRB's, the problem is the long-term cost to your community in trying to finance these projects?

Mr. **Thomas**. I think the benefits to us of a drop in the overall level of interest rates would be far greater than whatever narrowing we could get between taxable and nontaxable through restrictions on IRB's.

Mr. **Anthony**. Well, I thank you very much for your testimony.

Let me just state not as temporary chairman of this committee today, but as the most junior member sitting way down on the far left, I totally support the continuation of these IRB's. If they were not in existence today, you could just have wrapped up the State of Arkansas and shipped it off someplace else.

I will be happy to work with you to see that the abuses are taken out.

Mr. Stark?

Mr. **Stark**. No questions.

Mr. **Anthony**. Mr. Stark, do you have any questions?

Mr. **Stark**. No, sir, Mr. Chairman.

Mr. **Anthony**. Thank you very much.

Mr. **Thomas**. We would like to ask the committee to come down and view some of these projects and also the azaleas and the dogwood are beginning to bloom.

Mr. **Anthony**. Next we have a panel, the National Association of Recycling Industry, Inc., M. J. Mighdoll, executive vice president, accompanied by Edward Merrigan, counsel.

Cogeneration Coalition, Inc., Michael J. Zimmer, counsel; National Solid Wastes Management Association, Harold Gerschowitz, chairman.

And PPG Industries, Inc., William R. Harris.

Welcome, gentlemen, and we will get you all properly identified and we will proceed as your names were called with Mr. Mighdoll leading off.

STATEMENT OF M. J. MIGHDOLL, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF RECYCLING INDUSTRIES, INC.

Mr. **Mighdoll**. Thank you, Mr. Chairman.

We thank you and the committee for permitting us to testify today on the subject of why Congress should reject the administration's proposals to terminate business energy tax credits generally and the recycling investment tax credit in particular.

We urge the committee, in the national interest, to make the recycling tax credit, which has only been in effect for approximately 3 years and which is due to expire under present law on December 31, 1982, permanent.

At the very least, it should be extended for a full 5-year period, that is, through December 31, 1987.

Clearly, of all the business energy tax credits, continuation of the recycling tax credit is, by far, the most essential to the United States. It is the only economic means provided by the Federal Government to maximize industrial recyling, whereas maximum industrial utilization of recycled metals, paper, textiles, and rubber is today, and will, in the years ahead, become increasingly crucial to the national security and economic well-being of our Nation.

In this connection, study after study made by the Federal Government has established that:

First, industrial use of recyclables conserves our depleting supplies of critical natural resources.

Second, industrial use of recyclables reduces the United States' growing reliance on undependable foreign sources of supply for essential industrial virgin raw materials, especially minerals and metals.

Third, industrial use of recyclables here in the United States improves the Nation's perilous balance of payments and balance of trade positions.

Fourth, industrial use of recyclables results in amazing industrial energy conservation. A manufacturer utilizing recycled metals or wastepaper as raw materials in its production facilities in place of their virgin raw material counterparts, saves 60 percent to 95 percent of the gas, oil or electricity required to manufacture the same quality products.

Fifth, industrial use of recycled metals or paper in place of their virgin raw material counterparts simultaneously reduces plant air pollution, water pollution and water utilization by as much as 60 percent or 80 percent.

Sixth, industrial use of recyclable materials substantially assists cities and States throughout the country in coping with both solid waste disposal and hazardous waste pollution.

This is the only economic incentive the Federal Government has ever provided to encourage increased industrial recycling is the very modest 10 percent recycling investment tax credit we are discussing today—and now, of course, the administration is threatening to take that away.

Since the recycling credit has been in effect for only three years, the Treasury has not published official figures regarding its cost.

But, when it was enacted in 1978, both the Treasury and the Joint Committee on Taxation gave these estimates of its projected cost to the Government:

Year and revenue impact: 1979, $31 million; 1980, $33 million; 1981, $38 million; and 1982, $41 million.

I want to emphasize, Mr. Chairman, that the recycling tax credit is available only in cases where investments are made in equipment to increase current recycling volumes, it has always been our contention that the credit seldom, if ever, results in any real net revenue loss to the Treasury.

In most such cases, when an industrial concern increases its production levels, it increases its sales, its income and its taxes.

Thus, in those instances, at least, the Treasury should realize revenue gains on the increased income which would be more than sufficient to offset the revenue loss from the recycling credit.

Moreover, when compared with the permanent tax incentives historically provided by the Internal Revenue Code to industrial taxpayers for the continuing depletion of virgin natural resource raw materials that necessarily compete with their recyclable material counterparts, the recycling tax credit is very modest, indeed.

In this regard, the Federal Government for decades has provided first, a percentage depletion allowance as an economic incentive for industrial utilization—and depletion—of virgin metals, which are becoming increasingly scarce here in the United States.

It has also, second, provided for the taxation of income from the sale of timber used as a virgin raw material in paper manufacturing at capital gains rates.

The Government estimated that these two economic incentives were worth as much as $2 billion a year to the virgin material production sectors.

In recent years, those economic benefits have increased substantially as Congress reduced the capital gains rate from 32 percent to 26 percent—and in 1980, to 20 percent.

Prior to the reduction of the capital gains rate from 32 percent to 26 percent, the Treasury Department estimated that these two virgin material tax benefits cost the Government more than $800 million a year, and it is estimated that currently the cost is more than $1 billion annually.

This, of course, compared with a maximum recycling credit cost of only $41 million per year at the most.

The National Association of Recycling Industries, which I represent before this committee, is not here to urge the elimination or reduction of these tax benefits historically provided by the Federal Government as an incentive for continuing depletion and industrial utilization of scarce virgin metal and paper raw materials.

However, we are here to ask this question: At a time when the United States is facing dangerous shortages of virgin raw materials and energy at home, and equally dangerous portents regarding its foreign source of supply, how can the administration, which seems to be obsessed with the vital importance of national security, possibly support continuing, increased economic incentives for the depletion of scarce, vitally essential domestic natural resources that cost more than $1 billion a year, while it simultaneously urges Congress to terminate the only economic incentive the Government provides for increased industrial recycling—an incentive that costs no more than $41 million a year?

The point I intend to make, of course, is that, at a time when resource and energy conservation should be paramount in the minds of our policymakers, it is astounding to find the administration proposing complete cancelation of the Government's sole modest economic incentive for resource and energy-saving industrial recycling, while it proposes no change whatsoever in the multiple economic incentives the Government has historically provided—and recently increased—for resource- and energy-depleting industrial operations.

Finally, extension of the recycling tax credit is essential as we try to work our way out of this economic recession—or depression—to stimulate new investments and increased production in the recycling industries.

As mentioned above, the credit applies only in cases of increased recycling, so each dollar of credit allowed will represent true economic recovery in the recycling industry.

Since approximately mid- to late-1981, recyclable aluminum, copper, lead, zinc, and steel utilization has sharply declined, with similar—if not worse—economic patterns in other sectors of the recycling industry.

Nothing could be more damaging than sudden termination of the recycling tax credit at this time—after only 3 years of its availability.

Therefore, Mr. Chairman, we urge this committee to favorably report legislation at the earliest possible date that will make the tax credit permanent or extend its availability through December 31, 1987.

Thank you.

[The prepared statement follows:]

STATEMENT OF M. J. MIGHDOLL, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF RECYCLING INDUSTRIES, INC., ACCOMPANIED BY EDWARD L. MERRIGAN, COUNSEL

Mr. Chairman, we wish to thank you and the Committee for permitting us to testify on the vitally important subject of why Congress should reject the Administration's proposal to terminate Business Energy Tax Credits generally—and the Recycling Investment Tax Credit in particular.

We urge the Ways and Means Committee, in the national interest, to make the Recycling Tax Credit, which has only been in effect for approximately three (3) years and which is due to expire under present law on December 31, 1982, permanent. At the very least, it should be extended for a full five-year period, i.e., through December 31, 1987.

Clearly, of all the Business Energy Tax Credits, continuation of the Recycling Tax Credit is, by far, the most essential to the United States. It is the only economic incentive provided by the Federal Government to maximize industrial recycling, whereas maximum industrial utilization of recycled metals, paper, textiles and rubber is today and will, in the years ahead, become increasingly crucial to the national security and economic wellbeing of our nation. In this connection, study after study made by the Federal Government has established that:

1. Industrial use of recyclables conserves our depleting supplies of critical natural resources.
2. Industrial use of recyclables reduces the United States' growing reliance on undependable foreign sources of supply for essential industrial virgin raw materials, especially minerals and metals.
3. Industrial use of recyclables here in the United States improves the nation's perilous balance of payments and balance of trade positions.
4. Industrial use of recyclables results in amazing industrial energy conservation. A manufacturer utilizing recycled metals or wastepaper as raw materials in its production facilities in place of their virgin raw material counterparts, saves 60 to 95 percent of the gas, oil or electricity required to manufacture the same quality products.
5. Industrial use of recycled metals or paper in place of their virgin raw material counterparts simultaneously reduces plant air pollution, water pollution and water utilization by as much as 60 to 80 percent.
6. Industrial use of recyclable materials substantially assists cities and states throughout the country in the fierce, costly battles they are waging to endeavor to cope with both solid waste disposal and hazardous waste pollution.

Since the Federal Government has repeatedly recognized how vitally important maximum industrial recycling is to the United States now—and that it will become even more essential in the years ahead—it would be reasonable to suspect that the Government must be providing numerous, extremely costly economic incentives to the recycling industry—as it did, for example, to maximize the production of synthetic rubber and as it is currently doing in an effort to maximize the production of synethetic fuels and to develop new sources of energy.

However, that is not the case. The only economic incentive the Federal Government has ever provided to encourage increased industrial recycling is the very modest 10 percent Recycling Investment Tax Credit we are discussing today—and now, of course, the Administration is threatening to take that away. Since the Recycling Credit has been in effect for only three (3) years, the Treasury has not published official figures regarding its cost. But, when it was enacted in 1978, both the Treasury and the Joint Committee on Taxation gave these estimates of its projected cost to the Government:

Year and revenue impact: 1979 $31 million, 1980 $33 million, 1981 $28 million, and 1982 $41 million.

Considering the statutory requirement that the Recycling Tax Credit is available only in cases where investments are made in equipment to increase current recycling volumes, it has always been our contention that the Credit seldom, if ever, results in any real net revenue loss to the Treasury. In most such cases, when an industrial concern increases its production levels, it increases its sales, its income and its taxes. Thus, in those instances at least, the Treasury should realize revenue gains on the increased income which would be more than sufficient to offset the revenue loss from the Recycling Credit.

Moreover, when compared with the permanent tax incentives historically provided by the Internal Revenue Code to industrial taxpayers for the continuing depletion of virgin natural resource raw materials that necessarily compete with their recyclable material counterparts, the Recycling Tax Credit is very modest indeed.

In this regard, the Federal Government for decades has provided a percentage depletion allowance as an economic incentive for industrial utilization (and depletion) of virgin metals, which are becoming increasingly scarce here in the United States. It has also provided for the taxation of income from the sale of timber used as a virgin raw material in paper manufacturing at capital gains rates.

As long ago as 1970, the Government estimated that these two economic incentives were worth as much as $2 billion a year to the virgin material production sector. And, in recent years, those economic benefits have increased substantially as Congress reduced the capital gains rate from 32 to 26 percent—and in 1980, to 20 percent in some cases.

Prior to the reduction of the capital gains rate from 32 to 26 percent, Treasury Department estimated that these two virgin material tax benefits cost the Government more than $800 million a year, and it is estimated that currently the cost is more than $1 billion annually. This of course, compared with a maximum Recycling Credit cost of only $41 million per year at the most!

The National Association of Recycling Industries, which I represent before this Committee, is not here to urge the elimination or reduction of these tax benefits historically provided by the Federal Government as an incentive for continuing depletion and industrial utilization of scarce virgin metal and paper raw materials.

However, we are here to ask this question: At a time when the United States is facing dangerous shortages of virgin raw materials and energy at home, and equally dangerous portents regarding its foreign sources of supply, how can the Administration, which seems to be obsessed with the vital importance of national security, possibly support continuing, increased economic incentives for the depletion of scarce, vitally essential domestic natural resources that cost more than $1 billion a year, while it simultaneously urges Congress to terminate the only economic incentive the Government provides for increased industrial recycling—an incentive that costs no more than $41 million a year?

The point I intend to make, of course, is that, at a time when resource and energy conservation should be paramount in the minds of our policy-makers, it is astounding to find the Administration proposing complete cancelation of the Government's sole modest economic incentive for resource and energy-saving industrial recycling, while it proposes no change whatsoever in the multiple economic incentives the Government has historically provided—and recently increased—for resource- and energy-depleting industrial operations.

The only explanation for the Administration's proposal I have been able to find appears in the Budget it submitted to the Congress, at page 4-11: "With decontrol of oil and natural gas prices, businesses no longer need additional investment incentives for energy conservation and the development of alternative energy sources. Such subsidies interfere with business decisions by preempting free market resource allocations."

This explanation plainly has no relevance to the Recycling Tax Credit and it completely fails to answer the question propounded above. Decontrol of oil and natural gas prices has nothing to do with this. The Recycling Tax Credit is absolutely essential to promote maximum increased industrial recycling and to offset, to a degree at least, the comparatively huge economic incentives provided by the Government that operate to preclude increased industrial recycling in the United States.

Finally, extension of the Recycling Tax Credit is essential as we try to work our way out of this economic recession—or depression—to stimulte new investments and increased production in the recycling industries. As mentioned above, the Credit applies only in cases of increased recycling, so each dollar of Credit allowed will represent true economic recovery in the recycling industry. Since approximately mid- to late-1981, recyclable aluminum, copper, lead, zinc and steel utilization has sharply declined, with similar (if not worse) economic patterns in other sectors of the recycling industry.

Nothing could be more damaging than sudden termination of the Recycling Tax Credit at this time—after only 3 to 4 years of its availability—to the stimulation of both new investments and new business in the recycling industries.

CONCLUSION

The more than 1,200 member firms of the National Association of Recycling Industries, Inc. located throughout the United States—including collectors, processors and industrial users of recyclable metals, paper, textiles and rubber—urge this Committee favorably to report legislation at the earliest possible date which will either make the Recycling Tax Credit permanent or extend its availability through December 31, 1987. This action must be taken as soon as possible to make it known that the Credit will continue to be available to firms in the recycling industry which hope to emerge from the depths of the current recession through investments in new recycling equipment necessary to stimulate new production capacity and economic growth.

Mr. ANTHONY. Thank you very much, Mr. Mighdoll.

Mr. Zimmer.

STATEMENT OF MICHAEL J. ZIMMER, WASHINGTON COUNSEL, COGENERATION COALITION, INC.

Mr. **Zimmer**. Thank you, Mr. Chairman.

I am here representing the Cogeneration Coalition, Inc., comprised of industrial users, equipment manufacturers, project development companies, and engineering consulting firms that have been focusing in the area of cogeneration development.

It would be useful to briefly describe what congeneration is Mr. Chairman.

By congeneration, we are speaking of the sequential use of energy to produce either electric or mechanical power and then on a secondary basis, useful thermal energy, usually in the form of heat or steam.

The types of industries to which cogeneration can be applied are also very interesting and potentially useful to provide perspective to members of the committee. These potential applications include, industrial facilities, particularly in the food processing area, pulp and paper, steel, chemical and refining industries, alcohol fuel plants, water purification facilities, desalinization and agricultural facilities, multifamily residences, universities, hospitals, military bases, and also municipal district heating systems.

One of the key elements in these applications is a proper matching of steam with electric requirements.

We are here to testify today specifically to indicate alarm and to strongly oppose any attempts to rescind or discontinue the business energy tax credit provisions in the Internal Revenue Code.

We support extension of those tax credit provisions, subject to the need for certain modifications, to improve the effectiveness of the cogeneration tax credit.

Such an extension, we would hope, would be a part of any major tax legislation enacted during this session of the 97th Congress.

The short-term stimulation of energy conservation is desirable. Experience with the investment tax credit, as far back as 1962, has shown this approach to be effective in stimulating desirable capital investment.

A recent study by the Arthur D. Little Co. indicates the effectiveness of the energy tax credit for business on a conceptually applied basis.

The availability of the tax credits would not precipitate premature replacement of equipment since tax credits do not substitute for sound and reasonable business judgment.

However, in light of the current business and investment climate, the business energy tax credit would serve the critical function of elevating energy efficiency improvements to a higher level within corporate planning and investment decisionmaking.

As indicated previously by Representative Wyden, the business energy tax credit offers opportunities for increasing tax revenues within brief periods of time through positive feedback effects from reduced deductible expenses, and permanent increases in desirable economic activity associated with providing energy efficiency improvements in the various applications which I previously mentioned.

As indicated, the tax credit could be improved as well as extended in light of its pending expiration date on the last day of this year.

Such improvements should recognize that in the short term, cogeneration investments where applicable, offer the greatest promise for increased energy savings when compared with other energy efficiency technologies.

This is important because we are talking about technologies that have been developed and are currently available and in place ready for use.

In concluding, beyond extending the business energy tax credit, some of the modifications or areas of possible improvement that we would suggest to members of the committee are modifying the definition of cogeneration equipment to include equipment that provides mechanical power, as well as electrical power; second, making that credit available for equipment installed in new, as well as in existing, facilities; third, providing the tax credit for oil- and gas-fired cogeneration equipment; and finally, removing the public utility property exclusion for the tax credit which is currently provided in the Internal Revenue Code.

We thank you for the opportunity to appear before the committee this morning and would be pleased to discuss these issues with you further or answer any questions you may have.

[The prepared statement follows:]

STATEMENT OF MICHAEL J. ZIMMER, WASHINGTON COUNSEL, COGENERATION COALITION, INC.

SUMMARY STATEMENT

The Cogeneration Coalition, Inc. views with alarm and strongly opposes any attempt to rescind or discontinue the business energy tax credit provisions of the Internal Revenue Code.

The Coalition supports the extension of the business energy tax credits, subject to certain modifications affecting the cogeneration tax credit. Such an extension should be a part of any major tax legislation enacted during this session of the 97th Congress.

Short-term stimulation of energy conservation is desirable, and experience with the investment tax credits since 1962 has shown this approach to be effective in stimulating desirable capital investment.

The availability of business energy tax credits will not precipitate premature replacement of old equipment since a tax credit will not substitute for sound and responsible business judgment. In light of the current business and investment climate, the business energy tax credit will serve the critical function of elevating energy efficiency improvements to a higher level within corporate planning and decision-making.

The business energy tax credit offers opportunities to increase tax revenues within a relatively brief period of time through positive feedback effects from reduced deductible expenses and permanent increases in desirable economic activity associated with providing energy efficiency improvements to industrial users.

The current cogeneration tax credit should be improved in light of its pending expiration on December 31, 1982. Such improvements should recognize that in the short-term cogeneration investments where applicable offer the greatest promise for increased energy savings when compared with other energy efficiency technologies.

Such improvements should include extending the current cogeneration tax credit to December 31, 1986; modifying the definition of cogeneration equipment; making the credit available for equipment installed in new facilities as well as for the total costs of the cogeneration system installed; providing the tax credit for oil- and gas-fired cogeneration equipment; and removing the current public utility property exclusion for the credit.

INTRODUCTION

The Cogeneration Coalition, Inc. ("Coalition") is a non-profit organization comprised of interested gas utilities, industrial users, industrial equipment manufacturers, project development companies, and engineering consulting firms.[1] The Coalition has also established advisory relationships with other public interest and trade association groups on cogeneration and other such energy efficiency issues. The Coalition has supported since 1980 the provision of necessary financial and tax incentives to promote the utilization of cogeneration resources and the removal of unnecessarily restrictive federal barriers to the development of potential cogeneration resources nationwide. (See Attachment 1)

The Coalition views with alarm and strongly opposes any attempt to rescind or discontinue the business energy tax credit provisions of the Internal Revenue Code, particularly in view of the diminishing cash resources, financing options, and high interest rates facing energy users investing in these energy efficiency improvements since 1978. In light of these current circumstances which have grown more severe since enactment of this program in 1978, as amended in 1980, the business energy tax credits should be extended through December 31, 1986.

THE COGENERATION TAX CREDIT SHOULD BE EXTENDED

Energy efficiency is clearly receiving a lower priority than energy supply incentives under the Reagan energy and tax programs. Fuel use restrictions have been replaced by policies promoting free choice, oil regulation replaced by decontrol, mandatory conservation displaced by market forces and prices, coupled with tax provisions such as the Accelerated Cost Recovery System for promoting business productivity investments and national economic recovery. The national energy policy debate has also shifted from intense evaluation of international considerations to U.S. budgetary concerns. The Cogeneration Coalition believes that the present business energy tax credits not only contribute to the long-term national objective of lowering oil imports and stimulating national economy recovery but also present some sound and persuasive arguments for continuation that will satisfy even the most conservative budgetary proposals presently under scrutiny.

The Windfall Profits Tax Act of 1980 ("Act") (P.L. 96-223) provided for the establishment of an energy investment tax credit for cogeneration equipment[2] in the amount of 10 percent beginning January 1, 1980 through December 31, 1982. To qualify for this tax credit, the equipment must be installed at an industrial or commercial facility in existence by 1980. There are further qualifications: the system cannot use oil or natural gas or any of their products as a primary fuel; if such fuels are used for startup, backup, or flame stabilization purposes, they cannot exceed 20 percent of fuel consumption by the system. Nor does equipment that merely increases a system's capacity to generate a primary energy product qualify under the Act.

During the fiscal year 1982 budget process, the Administration strongly supported the energy tax credit program as one of the cornerstones of its national energy policy.[3] Its recent change in position for fiscal year 1983 appears more motivated by budget concerns than based upon sound business and energy policy considerations. Such short-term policy shifts should be rejected by the Congress. Increasing energy efficiency is still viewed by many as one of the most effective, inexpensive, environmentally sound and permanent methods of offsetting oil dependency and reducing international vulnerability during the upcoming decade. The need for continued stimulation of such investments is paramount in light of the continuing decline in domestic fossil fuel supplies and forecast shortages in electric capacity projected for this decade.

Thus, short-term stimulation of energy conservation is desirable. Experience with investment tax credits since initial passage in 1962 has shown this approach to be effective in stimulating desirable capital investment. In House Report No. 95-1445, the House Ways and Means Committee stated "investments have increased when the credit has been made available and decreased when the credit was rescinded."[4]

---

[1] The current members of the Cogeneration Coalition, Inc. include: Kimberly Clark Corp., Brooklyn Union Gas Company, Great Lakes Carbon Company, H.O. Penn Machinery Co., National Urban Energy Corp., Daverman & Associates, Energenics Systems, Inc., Entek Research, Inc., and Williams & Works' Industrial Co-Energy Systems.

[2] Section 48(l)(14) of the Internal Revenue Code.

[3] *A Program for Economic Recovery* (Feb. 18, 1981), p. 4-20.

As previously noted by the National Association of Manufacturers before this Committee (*Id.* at 65): "Capital expenditures increased in the years following the original enactment in 1962 and again picked up after restoration of the credit in 1971 in the years following when the ITC was raised to the 10 percent level."

While the regulatory components of the Reagan energy strategy are sound, the economic and tax provisions may not do the crucial job of promoting gains in energy efficiency. Such efficiency losses will inure to the detriment of all ratepayers, industrial and commercial users, equipment manufacturers, project developers, engineering design firms, and both gas and electric utilities. The energy users with the greatest incentive to conserve the use of oil, natural gas and electricity are also the very same companies and users that lack sufficient capital to take full advantage of readily available energy-efficiency technologies. Recent analysis has illustrated sharpening pressures on pretax profits caused by escalating fuel and power costs from 17.1 percent of pretax profits in 1966 to 39.5 percent of pretax profits in 1978.[5] (See Attachment 2)

There are those who also argue energy tax credits precipitate premature replacement of old equipment. First, capital outlays for new equipment will not be solely contemplated on the availability of a tax credit. Higher energy costs, technical considerations, increased productivity, and other factors are additional incentives to purchase more efficient equipment. However, after these factors are evaluated, the availability of a business energy tax credit could make the crucial difference in a final investment decision within the corporation. Second, these purchases fit neatly into the Reagan Economic Recovery Program, pumping more money into the economy, creating more jobs, new businesses, and desirable economic growth.[6] Third, the tax credit itself may not per se guarantee capital intensive outlays on the part of industry but could be a definite quantum in the overall decision-making process. There may be old and marginal, but still quite operative facilities, that a tax credit incentive could possibly promote replacement investments with modern energy efficient devices.

In other words, a tax credit is not a substitute for sound and responsible business judgment. In a basic commodity industry that requires high investment for a historically low rate of return, the additional tax incentives provided would clearly help stimulate timely capital investments. Such investment in energy efficient technology would save significant amounts of energy in the long-term and dampen the inflationary effects of rising energy costs.

With respect to concerns voiced by the Treasury Department, in contrast to some tax incentives, the business energy tax credit offers opportunities to increase tax revenues within a relatively brief time. Tax credits can be tied to actual energy savings as in H.R. 2640.[7] Energy expenses are deductible expenses under Section 162 of the Internal Revenue Code as "ordinary and necessary" business expenses. Reduced energy costs have the potential to reduce tax deductions in deriving taxable income with positive feedback effects offsetting revenue losses from the tax credits themselves.[8] Further, the increased economic activity associated with the enhancement of energy efficiency generates additional taxable income with further positive feedback effects. This means that for every dollar of energy use saved by the investment, the Treasury in effect recovers increased tax revenues—revenue which would not have been collected but for the energy saving capital expenditure. Thus, continuation of the business energy tax credit program may in fact be more of an effective revenue enhancement measure than seeking its repeal or permitting its expiration.

---

[4] Industrial Energy Efficiency and Fuel Conversion Tax Incentive Act; Hearing before the Subcommittee on Taxation and Debt Management Generally of the Senate Committee on Finance, 96th Cong., 2d Sess. 65 (1980).

[5] "Fuel and Power Costs Compared with Pre-Tax Profits," Energy User News (Sept. 14, 1981), p. 17.

[6] For instance, the potential applications for cogeneration are rather extensive including industrial facilities, alcohol fuel plants, water purification, desalinization and agricultural facilities, multi-family residential buildings, universities, hospitals, military bases and municipal district heating systems.

[7] H.R. 3640 introduced by Representative Cecil Heftel (D-Ha.) and supported by several members of this Committee.

[8] Several recent studies have confirmed this contention which the Treasury Department continues to ignore. Arthur D. Little Company recently concluded in a study that revenue gains and losses for energy tax credits would balance with each other—if the present 15 percent tax credits for renewable energy resources were extended to 1991 and conventional fuel prices rise by 11 percent a year.

THE COGENERATION TAX CREDIT SHOULD BE IMPROVED

The energy tax credit for cogeneration investments expires on December 31, 1982. It is not only the position of the Cogeneration Coalition that this credit should be extended, it is also our position that this energy tax credit should be amended to promote a comprehensive scheme for the short and mid-term development of cogeneration as a matter of national energy and tax policy. The current business energy investment tax credit for cogeneration equipment is too restrictive, and fails to recognize that in the short-term cogeneration investments where applicable offer the greatest promise for increased energy savings compared with other energy efficiency technologies. As summarized, cogeneration equipment to qualify under current law must be installed in connection with a boiler or burner at an existing facility and must result in an expansion in the facility's cogeneration capacity. The annual use of oil or natural gas fuel in the systems must be less than 20 percent of all fuel used each year and must be limited to use as a startup, backup or flame stabilization fuel.

The Cogeneration Coalition specifically recommends that the cogeneration tax credit should be amended and extended to December 31, 1986 to include the following:

A. Modify the definition of cogeneration equipment to ensure that mechanical cogeneration qualifies for this tax credit, as well as cogeneration equipment that uses energy sources such as solar, biomass and geothermal energy.

B. Make the business energy tax credit available for cogeneration equipment installed in new facilities as well as modification or retrofit of existing facilities. New facilities are generally better-suited for cogeneration than the retrofitting of existing facilities. Such new facilities can be constructed from the outset to avoid numerous technical problems which are faced in the modification and retrofit of existing facilities.

C. Make the business energy tax credit for cogeneration equipment available for the total costs of the cogeneration system installed. The current business energy tax credit for cogeneration is limited to equipment which increases a system's capacity to produce electricity or useful energy, whichever is the secondary energy output of the system. Specifically, the credit should also be available for any pollution control equipment or loading and handling equipment required in connection with the cogeneration facility.

D. Ensure that the business energy tax credit for cogeneration equipment is available for oil and gas-fired equipment installed in a cogeneration facility. Omitting oil and gas or any of their products as primary fuel for purposes of this energy tax credit is counterproductive since the most effective and currently available cogeneration technologies are oil gas-fired. Current restrictions on use of oil and gas in cogeneration facilities in order to qualify for available federal tax incentives must be reexamined to recognize that only large sized cogeneration facilities possess the economies of scale and capital requirements to utilize coal. Furthermore, the only reasonable and available fuel choice in the interim is oil and gas for small and medium-sized cogeneration facilities. Use of oil and gas in a cogeneration facility offers increased efficiencies in use of these fuel inputs over use of such fuels in separate facilities. Also, the use of oil and gas in the interim can provide an important bridge or transition to synthetic fuels derived from wood, lignite, etc., for the long-term use in cogeneration applications.

E. Remove the current exclusion against public utilities qualifying for the business energy tax credit for cogeneration equipment, which is characterized as public utility property.

F. Require the Department of Treasury to promulgate proposed regulations to implement these modifications within 90 days after the date of enactment.

Legislation currently before this Committee considers these recommendations in part particularly in provisions of H.R. 2640. H.R. 5340 recently introduced by Representative Ron Wyden, with 29 cosponsors, would make permanent these business energy tax credits.[9] Such an extension of the business energy tax credits would be fundamentally consistent with the goals and objectives of the fiscal year 1983 budget effort.

---

[9] *See* Representative Wyden's floor statement, 128 CONG. REC. H46 (*daily ed.* January 26, 1982).

CONCLUSION

The Cogeneration Coalition submits that time is of the essence in sending a signal of stability and continuity to the ratepayers, industrial and commercial users, equipment manufacturers, project developers, engineering design firms, and gas and electric utilities with a stake in the outcome of this issue. This signal must entail extension of the business energy tax credits through December 31, 1986 for several critical reasons:

(1) Diminishing cash resources, financing options and high interest rates face energy users investing in energy efficiency improvements since 1978;

(2) The need for continued stimulation of such investments is paramount in light of the continuing decline in domestic fossil fuel supplies and anticipated shortages in electric capacity projected for this decade;

(3) After normal business investment factors are considered, the availability of a business energy tax credit could make the crucial difference in a final investment decision for energy efficiency improvements within the corporation;

(4) Reduced energy costs have the potential to reduce the tax deductions for energy operating expenses as well as generating increased economic activity from industries providing energy efficiency equipment and services. These developments all have positive feedback effects offsetting revenue losses from the energy tax credits themselves;

(5) The recently enacted depreciation schedules and R&D tax credit under the Economic Recovery Tax Act are not effective investment stimuli with respect to cogeneration projects; and

(6) Continuation of the business energy tax credit program may in fact be more of an effective revenue enhancement measure than seeking its repeal or permitting its expiration.

We appreciate the opportunity to appear before this Committee and will be pleased to answer any questions you may have.

Mr. ANTHONY. Thank you, Mr. Zimmer.

Mr. Gershowitz.

STATEMENT OF HAROLD GERSHOWITZ, CHAIRMAN, INSTITUTE OF RESOURCE RECOVERY, NATIONAL SOLID WASTES MANAGEMENT ASSOCIATION, SENIOR VICE PRESIDENT, WASTE MANAGEMENT, INC.

Mr. GERSHOWITZ. Thank you, Mr. Chairman.

I am here actually wearing two hats this morning. I am here as chairman of the Institute of Resource Recovery of the National Solid Wastes Management Association; I am also here in my capacity as senior vice president of Waste Management, Inc., which is the world's largest organization providing solid waste management services here in North America and abroad.

The Institute of Resource Recovery represents those companies in the United States that offer to municipalities waste-to-energy systems, both in delivery of the systems, and the operation of those systems.

Rather than read my statement, which is rather lengthy, I would put it aside and attempt to summarize my remarks and make a few salient points that I think are quite germane to your deliberations.

Today, we very much stand, I believe, at a crossroads with respect to how our municipalities will manage the waste products, the solid wastes produced within those communities. The refuse, if you will, of the daily commerce and the daily task of living.

We have essentially two alternatives and only two alternatives in the United States. One is land disposal, or sanitary landfill, which is where most of the waste in the United States is currently managed.

The other alternative is resource recovery, that is, the recovery of the greatest component of those wastes as possible in conversion of those materials to a useful byproduct.

In this case, energy, which all would recognize to be in great demand and very scarce.

As an aside, I would mention that my company is also the world's largest operator of engineered sanitary landfills so if there is any public policy initiative that goes forward that retards the use of resource recovery, it will be to the benefit of land disposal and from a corporate perspective, the other hat that I wear, we would probably benefit rather handsomely.

In terms of my role as the chairman of the Institute of Resource Recovery, I must say such a development would represent poor public policy for this reason, resource recovery today, that is the delivery of systems that destruct the waste and reduce them in volume very substantially, perhaps 95 percent, while simultaneously capturing the energy component of those wastes, are today very expensive systems.

They do not compete virtually anywhere in the United States with land disposal alternatives.

If we make some reasonable assumptions as to the future, it would appear they have a good shot of becoming economically viable by the end of this decade and rather attractive thereafter.

But there is a great deal of speculation in that assumption. So communities, in making a judgment for long-term planning that commits the community to either resource recovery or land disposal must of necessity look to earlier costs of the two alternatives.

The current combination of tax benefits that are available and which were intended to attract private capital to these systems includes tax-exempt industrial development bonds that are available to finance these systems, as well as a combination of tax benefits which affect the economics of these systems quite materially and quite directly the cost that the communities pay for these systems, because these tax benefits must be reflected in the economics of the system.

That includes the accelerated depreciation currently available; it also includes the investment tax credit; and for whatever time available, the energy tax credit.

If I might go over to the chart here, I think I can demonstrate the effect of each of these existing tax benefits to resource recovery and energy conversion and what the effect will be of any or all of these tax incentives.

I might add, there are currently between 100 and 150 communities in the United States that are spending substantial dollars in the planning and early-stage implementation of resource recovery systems, and we think that is good planning and good policy.

I would say that perhaps 75 or 80 percent of these instances, however, assume existing tax benefits will continue to be applied and if they are removed, I think I can demonstrate what the impact will be on these systems.

Mr. ANTHONY. Would you have that chart reproduced so we can circulate that?

Mr. GERSHOWITZ. Yes, Mr. Chairman.

[The chart follows:]

FINANCING & DEBT	Interest Rate	DISPOSAL COST PER TON TO MUNICIPALITY				
		Year 1	Year 2	Year 3	Year 4	Year 5
1. 100% of Tax Exempt IDB	13%	34.66	33.54	32.30	30.91	29.37
2. 100% of Taxable Bond	16%	42.65	41.54	40.29	38.91	37.37
3. Tax Exempt IDB with:						
a. Depreciation used to reduce debt	13%					
(1) Current Benefits		21.64	20.52	19.28	17.89	16.34
(2) Proposed Benefits		25.25	24.13	22.89	21.50	19.96
(3) 5 yr ACRS Benefits		19.83	18.71	17.47	16.08	14.54
b. Depreciation, and ITC used to reduce debt	13%					
(1) Current Benefits		18.32	17.21	15.97	14.58	13.04
(2) Proposed Benefits		21.94	20.82	19.58	18.19	16.65
(3) 5 yr ACRS Benefits		16.52	15.40	14.16	12.77	11.23
c. Depreciation, ITC, and ETC used to reduce debt	13%					
(1) Current Benefits		17.48	16.37	15.12	13.74	12.20
(2) Proposed Benefits		21.09	19.98	18.73	17.35	15.81
(3) 5 yr ACRS Benefits		15.68	14.56	13.32	11.93	10.39
4. Taxable Debt with:						
a. Depreciation used to reduce debt	16%					
(1) Current Benefits		27.19	26.07	24.83	23.44	21.90
(2) Proposed Benefits		31.47	30.36	29.12	27.73	26.19
(3) 5 yr ACRS Benefits		25.04	23.93	22.68	21.30	19.75
b. (1) Current Benefits	16%	23.26	22.14	20.90	19.51	17.97
(2) Proposed Benefits		27.54	26.43	25.18	23.80	22.26
(3) 5 yr ACRS Benefits		21.11	20.00	18.75	17.37	15.82
c. (1) Current Benefits	16%	22.25	21.14	19.90	18.51	16.97
(2) Proposed Benefits		26.54	25.43	24.18	22.80	21.26
(3) 5 yr ACRS Benefits		20.11	18.99	17.75	16.37	14.82

Assumptions

1000 TPD Waste to Energy Facility
Electricity for Sale at $.065/Kwh in Year 1

Capital Cost $70,800,000

Operating Cost: $20.00 per ton in Year 1

Escalation:

Electricity Price	9% per year
Operating Costs	7% per year

/cmb

Mr. Anthony. Go ahead.

Mr. Gershowitz. I have used the following assumption as to interest, that is, that taxable bonds would bring an interest rate of 16 percent and I am using 13 percent for the tax-exempt bonds. That could vary, obviously.

If we assume these facilities will be owned by the municipalities, and therefore, have the benefits of tax-exempt financing, but none of the other benefits of private ownership that would accrue to the economics of the system, such as accelerated depreciation and investment tax credit and so on, we see that these facilities in year 1—I will trace it from year 1 to year 5—would cost on a per-ton basis of processing, $34.66 a ton, assuming the following assumptions.

First, that we are talking about a 1,000-ton-a-day facility. That is medium to large size in the United States today.

Second, that we are assuming a 20-year life for the financing, that we are assuming a capital cost exclusive of reserve to financing costs of approximately $71 million to build a facility that will convert waste to electricity, which across the board, is a good composite number to use currently.

We are further assuming that the operating costs will escalate approximately 7 percent per year and that energy will escalate at 9 percent a year.

Change any of the assumptions and some of what I will now go over would also, by definition, change.

But they are good current working assumptions.

We find giving those assumptions at 13 percent tax-exempt financing, that we would have a first-year cost to the community of $34.66 a ton. That is net of the energy credit at 6½ cents a kilowatt hour, which is a pretty good average in the northern United States for electricity.

Over 5 years, assuming the 9-percent energy tax escalation and the 7-percent operating cost escalation, that cost would reduce to about $30, $39.37 cents per ton.

What that means is over the 5-year period of time, given that scenario of 13-percent tax-exempt financing, and no other tax benefits which are otherwise currently available, these systems will probably not compete with sanitary landfill.

That is to say, if tax-exempt financing and only tax-exempt financing is available, and not the other benefits currently available, in most areas of the country, a community cannot afford resource recovery, that is to say, the cost of landfill and transportation costs to a landfill over the next 5 years will, year-in and year-out, be considerable lower than the cost of resource recovery; waste-to-energy, if you will.

However, if you begin to look at the further impact of other tax benefits currently available, we see a markedly improved situation for resource recovery.

First, we will look at strictly the depreciation currently available in addition to the investment tax credit.

The current benefits would allow an 8-year writeoff, double declining balance for other than building and electrical components, for the disposal components, if you will.

Using that currently available depreciation schedule with the 13-percent tax-exempt financing, we find that the first-year cost is reduced to $21.64 or the economic improvement by $13.02 per ton.

Now, the administration proposes if tax-exempt financing is to be used, we would go to a 12-year straight-line depreciation schedule.

Under that circumstance, it would cost $25.25 a ton, or close to a $4 a ton penalty for the proposed depreciation schedule.

If we were allowed to use the 5-year accelerated capital recovery system in our computation, the first-year costs would drop to $19.83, or a savings, an improvement in the economics to the community ultimately, of $14.83.

Over the 5 years, under the current depreciation schedule, we would go from $29.37 for just tax-exempt financing to $16.34, a savings of over $13 a ton; and if we were allowed to use the 5-year capital recovery system, cost recovery, that would deescalate to $14.54, or an improvement of nearly $15 a ton, $14.92, to be exact.

So with current depreciation available to the system, with current depreciation available, in the first year, we would improve the economics by $13.02, in the fifth year, assuming the same escalation, the same $13 would apply.

Because the economics reflected by the availability of this depreciation in the bids made to the community must be reflected, or these systems cannot compete with landfill.

The $13 savings is a material and real to-be-realized savings by these communities. It is not a fiction, it is not a numerical gymnastic.

It represents a reduction in cost and improvement in the economics of these systems that accrue directly to the benefit of the community. The private company operating the system will compute in its proposal a return for its effort, a return on sales, a level of profitability, and in essence, pass the tax benefits of private ownership through to the community and the impact is quite substantial and most communities today looking at resource recovery systems are assuming private equity in the system and the benefits of private tax ownership accruing to the economics of the community.

If we go the next step and add to the depreciation currently available, the 10-percent investment tax credit currently available, we find a further improvement from $21.64 to $18.32, assuming tax-exempt financing, an improvement over $16 a ton available to the community, as compared to straight municipal ownership with tax-exempt financing.

At $18.32 a ton, which now incorporates the investment tax credit, we now become competitive in the first year with sanitary landfill when combined with transportation costs for many of our major cities in the United States.

On many of the large cities that are involved with long-distance transfer of wastes to outlying land disposal sites, combined transfer and disposal costs are in excess of $18 a ton——

New York, San Francisco, and Chicago, to name just a few, would be examples of communities that are now experiencing in 1982 combined transfer and disposal costs at or very close to the $18.32 number, which is what we can realize, given assumptions we have given you with current depreciation and current investment tax credit.

Take either one away in combination with tax-exempt financing, and we cannot compete with land disposal.

Add to that now the existence of the current energy tax credit to which Mr. Mighdoll addressed himself, and you find improvement from $18.32 in the first year of operation to $17.48.

That assumes the energy tax credit available prorated only to that portion that represents private equity in the system. Not that portion of total cost that is represented by tax-exempt financing.

So we now see from straight municipal ownership and tax-exempt financing, a decrease of $34.66 per ton, down to $17.48 per ton, for an improvement using existing current tax benefits of $17.18 a ton.

If we were able to apply the 5-year acclerated capital recovery system, we would get down to $15.68 a ton in the first year, or an improvement over first-year municipal ownership, using tax-exempt financing of nearly $19 a ton.

I will not labor the chart by going on because I have just described the best year and the best scenario. What I am representing to you, Mr. Chairman, is that a removal of existing tax benefits from the combination of tax benefits and tax-exempt financing is one and the same as establishing long-term commitments in this country for land disposal versus resource recovery.

From a corporate view, it is really irrelevant to our company because we are substantially committed to both land disposal, as well as resource recovery.

In terms of public policy, though, such a decision is clearly a commitment to long-term reliance on land disposal in the United States versus resource recovery and energy conservation.

Resource recovery is viable, it is viable in probably 5 to 7 years after startup of operation if we can accept certain assumptions as to energy escalation.

In the real world, communities will look for early-year comparisons and in those early years, it will be essential that currently existing tax incentives used to induce investment of private capital be applied to these systems.

If they are removed, but with the rarest of exceptions, resource recovery will not, cannot, compete with landfill or land disposal in the management of our Nation's waste and I feel that we will see the greater number of the 100 to 150 projects in the early planning stages clearly grind to a halt if this element of economics is removed from these systems.

So we would urge that the existing package of tax benefit which represents the Federal Government's only commitment to resource recovery, as defined in the Resource Conservation and Recovery Act of 1976, be maintained.

To remove them will represent a sharp reversal of current progress in the field and I feel that that is not conjecture, but hard facts.

Thank you very much.

[The prepared statement and letter follow:]

STATEMENT OF HAROLD GERSHOWITZ, SENIOR VICE PRESIDENT, WASTE MANAGEMENT, INC., AND CHAIRMAN, INSTITUTE FOR RESOURCE RECOVERY, NATIONAL SOLID WASTES MANAGEMENT ASSOCIATION

SUMMARY

1. NSWMA opposes federal grants, loans, price supports and similar project-specific assistance mechanisms and favors retention of existing tax incentives to fulfill the federal government's commitment to environmentally sound solid waste disposal and resource conservation.
2. Resource recovery plants to dispose of municipal solid waste are being planned in over 100 communities as a public/private partnership. They are one of the most expensive investments a community can make, taking about 3-4 years to build and place in operation.
3. The Administration's proposals to restrict industrial development bonds and eliminate energy tax credits could, at a minimum, result in expensive delays, but even worse, discourage these investments because the end effect is to increase disposal fees significantly. It will be difficult for local officials to support a facility which may cost taxpayers considerably more per ton in the early years of operation, with only a promise of becoming more economical in the long run.
4. The energy tax credit helps make materials recycling economically feasible with both environmental and energy conservation advantages.
5. Congress should retain eligibility for IDBs and energy tax credits for waste-to-energy projects.

STATEMENT

I am Harold Gershowitz, Senior Vice President of Waste Management, Incorporated, and Chairman of the Institute for Resource Recovery of the National Solid Wastes Management Association (NSWMA). The Institute represents members of our industry who build and operate resource recovery and energy conversion facilities. My company is the largest solid and chemical waste management organization in the nation and our Advanced Systems Group is committed—exclusively—to the development and delivery of full scale waste-to-energy systems for cities throughout North America.

I am here today to tell you that the Administration's recommendations to restrict industrial development bond financing and eliminate energy tax credits for solid waste disposal facilities are ill conceived. Their adoption will bring to an abrupt halt the timely development of waste-to-energy plants at the very time the first projects are struggling to their feet with the aid of the very incentives which the Administration proposes to eliminate. The result will be a defacto mandate for long term reliance on land disposal for the disposal of our nation's wastes. Incidentally, Waste Management is also the nation's largest operator of engineered sanitary landfills. So, I am not here today representing a special self interest. Indeed, I would expect our land disposal business to benefit from the proposed restrictions on tax exempt financing and other tax incentives for resource recovery systems. But such action will represent bad policy—and that is what I am here to discuss.

Existing tax law encourages private sector investors to support energy-producing waste disposal facilities. The local communities which these facilities serve are the beneficiaries of these tax incentives. In every case these benefits must be reflected through reduced costs to dispose of community wastes or these projects stand no chance of going forward. The Administration's proposals will increase disposal fees for resource recovery and delay procurement of waste-to-energy facilities. These facilities are extremely expensive, running anywhere from $60 to $70 thousand per ton of capacity to construct. That means a medium sized 1,000 ton per day plant will cost $60 to $70 million to build, and when interest, inflation and reserve requirements are added, we can expect one plant to result in total costs of $120 million or more to get into operation. Yet, they are the only realistic alternative to permanent reliance on landfill and, in time, rising energy values should make these facilities viable. But they need the incentives public policy currently provides if they are to be established and in place in the years just ahead.

Solid waste disposal facilities today represent a unique partnership between the private sector and the public sector at the local, state and federal levels. Let me explain this relationship because it is important to understand.

Every local community has a responsibility to ensure that solid waste disposal is provided in an environmentally safe and cost-effective manner. The environmental standards are established by state and federal regulatory agencies. About three-fourths of all wastes in the United States are managed by the private sector, and they are generally managed well. However, collection and disposal costs are both increasing due to rising energy costs for transportation, equipment cost escalation, and rising engineering and construction costs for landfill development.

Because of rising costs and other factors, many communities are examining disposal alternatives to landfill which may in the long run prove to be economically viable. Some communities simply do not have within their jurisdiction any remaining environmentally safe areas for new major landfills. Most alternatives being examined today center around wast-to-energy facilities which will be able to benefit from long term increases in energy costs. Waste-to-energy facilities should be able to provide a technically and economically viable solid waste disposal option over the long term.

During the past decade, the federal government and the Congress recognized the national scope of solid waste disposal problems, and additionally, recognized the contribution that thermal destruction of solid wastes could make in offsetting fossil fuel usage when the energy produced from such systems is harnessed and used within the community. The resource Conservation and Recovery Act of 1976 (RCRA) listed specific goals for solid waste disposal and recovery of usable energy and materials. The energy Security Act of 1978 further recognized the energy contribution of this industry. These two Acts represent a mandate by Congress to dispose of solid waste in an environmentally sound manner and to encourage the development of energy recovery from solid waste.

These federal initiatives, followed in many instances by parallel state initiatives, took two forms with respect to financing projects. One form was projet-specific assistance such as study grants, construction grants and loans for unique processes, R&D loans, loan guarantees, price support loans and entitlements. NSWMA opposed these financing programs vigorously because they tended to pit "grantsmen" against market oriented enterprises that have the technical and financial resources to develop and complete a project and make it work. The temptation to line up, hoping for federal funds, generally retards rather than enhances local initiative.

The second fiscal initiative sponsored by the federal government was in the form of tax incentives to encourage investment in resource recovery projects. We supported this type of stimulus by the federal government because it allows certain tax benefits to ultimately be passed on to local communities who then benefit through lowered disposal costs. Equally important, because tax programs have been relatively slow to change, when compared to grant and loan guarantee programs, private companies and communities were able to make long-range plans for project financing. Today, however, tax incentive programs are being questioned, introducing uncertainty with respect to financing alternatives. The IDB proposals by the Administration are causing uncertainty among investors and are disrupting plans that have been worked out over the past 12 to 24 months with specific communities. This disruption will cause delays in project implementation which can be translated into greater cost to the citizens and delay in implementing environmental standards. More important, very few communities will adopt resource recovery-energy conversion programs if such projects result in higher costs imposed by the loss of tax incentives now in place. In time, resource recovery will not require these tax incentives, but today they are absolutely essential.

Over 100 communities are planning solid waste disposal facilities today in the U.S. and we project that one-third may be built in the next 10 years if current financing alternatives are available. Thirty to forty of these projects will cost in excess of $60 million for the capital outlay alone. Most of the facilities will include an energy recovery option in the form of electricity, steam, or both. Several communities are considering replacing fossil-fuel district heating plants with a solid waste-to-energy system as the heat source. In the past year, 12 local authorities have selected a contractor to construct and operate a major waste-to-energy plant. These 12 plants could be operational within the next 3 to 4 years. All of these communities will have to obtain financing. The Administration's proposal will retard, if not terminate, this progress.

As the situation now stands, communities, acting under the federal and state mandate to give up outmoded and environmentally unsound open dumps and incinerators, are considering modern waste volume reduction facilities and, where economical in the long term, will probably procure one. They are, for the most part, looking to the private sector to build and operate the facility and to own the facility if possible.

Financing waste-to-energy facilities is proving to be difficult. Many communities do not have available authority to fund a project through general obligations bonds. Thus, the principal financing instrument available is tax-exempt industrial development bonds. When certain other tax incentives are included through private sector involvement, a financing package can be developed which will substantially reduce the ultimate cost of disposal to the community.

The point of my presentation is that the Administration proposes to reduce or eliminate many of the tax benefits that serve to attract investors to waste-to-energy projects. Elimination of these incentives will result in much higher costs to the communities as well as delays in implementation.

Municipalities and private sector investors may consider financing alternatives which include the use of tax-exempt IDBs (worth 250 basis points in interest rates), energy and investment tax credits (250 basis points each), and accelerated depreciation (250 basis points). The Administration has proposed elimination of the energy tax credit and denying use of accelerated depreciation with tax-exempt financing. With financing options reduced, a municipality could experience an increase in interest up to five percent. The cost could be translated into an increased fee of from $10 to $20 per ton when all costs are considered.

We would also question the wisdom of eliminating certain waste disposal steam generating facilities from eligibility from tax exempt financing. Such a proposal overlooks the fact that providing waste disposal services is a governmental responsibility which has been encouraged to develop into a public-private partnership. If the facility generates and sells energy and the revenues derived are used to lower the disposal fee that the community or its citizens ultimately pay, then, logically, the debt instruments issued to pay for all components of the facility, including pollution controls, should also be tax exempt. Further, if the community can attract capital at lower cost through use of tax incentives such as tax-exempt bonds and accelerated depreciation, incentives which serve to additionally lower the disposal fee, then these incentives should also be continued. We submit that the combination of these incentives represents the federal government's mandate for resource recovery and energy security. They are the sole remains of a federal commitment to encourage modern waste disposal facilities such as resource recovery-energy conversion plants.

I would like to point out that typically, it will take 3 to 4 years to build and place into operation a waste-to-energy facility. The construction contractor will employ up to 200 workers during this period. When completed, the facility will employ 60 to 75 full-time staff. It will commence returning taxes to the treasury as soon as construction begins.

The energy tax credit should be extended. It is a small investment to stimulate a major shift in our disposal practices toward resource recovery. It is also good public policy.

Finally, hazardous waste facilities are not considered eligible for IDB financing by the IRS, notwithstanding the fact that Congress defined solid waste to include hazardous waste in the Resource Conservation and Recovery Act. We urge the Congress to remind the Department of the Treasury of the provisions of this legislation which was enacted in 1976. Use of IDBs to promote an acceleration in investment in modern hazardous waste treatment facilities would represent the highest and best use of this particular tax incentive.

In summary, we believe that the Administration's proposals with respect to tax incentives for solid waste and pollution control facilities should be rejected. Retention of these tax incentives represents an appropriate level of participation by the federal government in promoting environmentally safe solid waste disposal methods as required by the Resource Conservation and Recovery Act. They contribute to conserving energy as mandated by the Energy Security Act of 1978. These incentives attract private investors to these projects. The tax benefits are then used to lower the costs to the community as their value is reflected in the project economics. We believe they serve a vital public purpose and are needed to encourage implementation of modern energy producing resource recovery projects.

Thank you.

Waste Management, Inc.,
Oak Brook, Ill., April 9, 1982.

Hon. Marty Russo,
House Ways and Means Committee,
Longworth House Office Building, Washington, D.C.

Dear Congressman Russo: I wanted to respond more fully to your question following my testimony before the House Ways and Means Committee on April 5, 1982. You asked whether tax benefits available to the private sector resulted in an apparent subsidy of the contractor's Operating Fee. The answer is no. There is no such subsidy. The confusion arose because, in the case I used, the Operating Fee was $20.00 per ton while the municipal Disposal Fee per ton was less than $20.00.

The Operating Fee must not be confused with the municipality's Disposal Fee. The economic relationships are expressed by the following equation.

Disposal fee equals debt service plus contractor's operating fee minus energy revenues.

The Disposal Fee which the city incurs is a composite of the debt service to be paid, and the contractor's charge for operating the facility reduced by the energy revenues. In my presentation, I defined the cost of operating the facility as the Operating Fee.

The tax benefits result in a reduction in the debt service while the contractor's Operating Fee is generally competitively established during the procurement process. The ultimate Disposal Fee (or net cost to the community) determines the economic feasibility of the project. The Disposal Fee is determined when project costs (Operating Fee and debt service) are reduced by the energy credits generated by the project.

Sincerely,

HAROLD GERSHOWITZ,
Senior Vice President.

Mr. ANTHONY. Thank you, Mr. Gershowitz.

Mr. Harris.

STATEMENT OF WILLIAM R. HARRIS, VICE PRESIDENT AND GENERAL MANAGER, INDUSTRIAL CHEMICAL DIVISION, PPG INDUSTRIES, INC.

Mr. HARRIS. Thank you, Mr. Chairman.

I am vice president and general manager of the Industrial Chemical Division of PPG Industries, Inc., headquartered in Pittsburgh, Pa.

I appreciate this opportunity to present PPG's views and request that our written statement, as previously submitted, be included for the record.

PPG is a major manufacturer of glass, chemicals, coatings and resins, and fiberglass. It employs some 28,000 people domestically in 41 manufacturing and research facilities in 17 States.

PPG is a substantial user of all forms of energy in its manufacturing processes.

In 1980, the company consumed about 105 trillion Btu's of energy. This was down from 1976 consumption of 139 trillion Btu's.

Overall, the corporation has improved its energy efficiency by more than 23 percent since 1972, while increasing production and sales.

While the subject of these hearings is clearly the broad and very complex revenue-raising proposal of the administration, my purpose today is to focus on one small, but important part of that package, the business energy tax incentives.

PPG believes the elimination of existing energy tax credits is not consistent with the administration's goals to strengthen the economy, reduce inflation, increase productivity and stimulate capital formation for futher productive investment.

The use of tax credits as an incentive to stimulate modernization of industrial processes used by industry is a concept well-established by our tax system.

The use of tax credits was first approved by Congress as part of the Revenue Act of 1962. Congress further recognized the incentive potential of investment credits when it enacted the Energy Tax Act of 1978 to utilize energy investment credits as an incentive to encourage industrial energy conversion and conservation.

The 1978 act provided for 11 specified items of what is called "specially-defined energy property" to qualify for energy tax credits and for authority from the Secretary of the Treasury to specify additional qualifying property for tax credits by regulations.

To our knowledge, the secretarial authority has not been exercised to qualify a single item in this category, despite the fact that these provisions are scheduled to expire at the end of 1982.

Proposed regulations were issued concerning the procedures for applying for qualification as specially defined energy property in January 1981; public hearings were held in April, and there has been no other action.

Aware of the fact that the energy tax credits would expire at the end of 1982, PPG attempted to satisfy the administrative requirements for obtaining a determination of eligibility for energy savings improvements to its chlor-alkali facilities. There has been no response.

A $100 million energy conservation project, PPG has under way at one of its chlor-alkali plants, which uses electricity generated by oil and natural gas, would reduce energy consumption by some 460,000 barrels of fuel oil equivalent each year. An estimated energy savings at one plant of 25 percent.

This project would fall in the mid-range of the "qualified industrial energy efficiency property" [QIEEP] concept contained in representative Heftel's bill, H.R. 2640, pending in the House, and its companion bill, S. 750, on which we have testified in the Senate.

Without a favorable tax ruling or legislative action and an extension of time to qualify, the current project will be denied the tax credit anticipated when it was funded, and installation of energy-saving technology by PPG and other companies in the chlor-alkali industry will likely give way to other corporate investments for a number of years.

The argument has been made that the accelerated cost recovery system [ARCS] provisions of the Economic Recovery Tax Act of last year removed the need for energy tax credits.

However, a comparison of the application of ACRS and its predecessor, the asset depreciation range [ADR], capital cost recovery systems to chemical industry machinery and equipment, indicates no significant improvement in the depreciation or cost recovery incentive is provided by ACRS.

The energy tax credit was intended to make energy conservation or conversion investments a little more attractive than other types of investment to those who must make significant investment decisions.

This rationale for the energy tax credit is as applicable today under ACRS as it was under the old ADR system.

The lack of guidelines as to what qualifies, coupled with the approaching December 31, 1982 deadline, has given industry no real signals for making major energy saving expenditure decisions.

In the competition for investment capital, energy saving projects are competing with other investment opportunities. Management must receive clear signals on what tax credits will or will not be available in order to make these judgments.

We recommend that the credit not be repealed, that the definition of qualified property be expanded and the expiration date be eliminated or extended.

We believe the intent of Congress, when it enacted the Energy Tax Act of 1978, has not been realized; that continuation of energy tax credits is essential to moving the Nation toward greater energy independence, and that credits complement the overall objectives of strengthening the economy, reducing inflation, increasing productivity, and adding to inplace capital formation efforts.

We believe that energy tax credits pay for themselves, free up generated capital for further investment, encourage modernization of U.S. plants and are significant incentives to encourage industry to help move our country towards energy self-sufficiency.

My testimony focuses on one small aspect of the administration's revenue-raising proposal with very significant impact on PPG Industries.

However, PPG also realizes the importance of reducing the difference between projected Federal revenues and expenditures.

We believe of greatest importance, in reducing the projected deficit, are ongoing spending reductions throughout the Government. On the side of increasing revenue, we believe close attention should be paid to the broad variety of user fees and excise taxes addressed in the administration's proposal.

In addition, the deregulation of natural gas, which continues to be discussed in the Congress, offers promise of significant increases in revenue.

I appreciate this opportunity to testify before the committee and would be happy to try to answer any questions.

[The prepared statement follows:]

STATEMENT OF WILLIAM R. HARRIS, VICE PRESIDENT AND GENERAL MANAGER, INDUSTRIAL CHEMICAL DIVISION, PPG INDUSTRIES, INC.

SUMMARY

I appreciate the opportunity to appear before the Committee to express PPG's views on the Administration's revenue raising proposal, particularly that part which concerns the business energy investment credit.

Congress passed the Energy Tax Act of 1978 to provide incentives to encourage industrial energy conservation. The 1978 Act provided for 11 specified items of energy property to qualify for energy tax credits, and for authority for the Secretary of the Treasury to specify additional qualifying property for tax credits by regulations. To our knowledge, the Secretarial authority given by Congress has not been exercised to qualify a single item in this category despite the fact that these provisions are scheduled to expire at the end of 1982.

PPG attempted to satisfy the administrative requirements for obtaining a determination of eligibility for energy-saving improvements to its chlor-alkali facilities. Based on the similarity with alumina electrolytic cells, we had also proceeded with a modification program at one of our chlor-alkali facilities with the expectation that this application would be approved. There has been no response from the I.R.S.

Without a favorable ruling or legislative action and an extension of the time to qualify, a current $100 million project at one of PPG's chlor-alkali facilities will be denied the tax credits anticipated when it was funded, and installation of this energy-saving technology by PPG and other companies in the chlor alkali industry will likely give way to other corporate investments for a number of years. PPG's current project, if completed, will reduce energy consumption by some 460,000 barrels of fuel-oil equivalent per year.

The energy tax credit was intended to make energy conservation or conversion investments more attractive than other types of investments to those who must make significant investment decisions. This rationale for the energy credit is as applicable today under the Accelerated Cost Recovery System (ACRS) as it was under the old Asset Depreciation Range (ADR).

PPG is opposed to the elimination of business energy investment credits as contained in the Administration's revenue raising proposal. We believe to take such action would be inconsistent with the Administration's goals to strengthen the economy, reduce inflation, increase productivity, and stimulate capital formation for further productive investments.

We believe the intent of Congress, when it enacted the Energy Tax Act of 1978, has not been realized, that continuation of energy tax credits is essential to moving the Nation toward greater energy independence, and that credits complement the overall objectives of strengthening the economy, reducing inflation, increasing productivity, and adding to in-place capital formation efforts. We believe energy tax credits pay for themselves, free up generated capital for further investment, and are significant incentives to encourage industry in total to help move our country toward energy self-sufficiency.

However, PPG also realizes the importance of reducing the difference between projected federal revenues and expenditures. We believe of greatest importance, in reducing the projected deficit, are ongoing spending reductions throughout the government. On the side of increasing revenue, we believe close attention should be paid to the broad variety of user fees and excise taxes addressed in the Administration's proposal. In addition, the deregulation of natural gas, which continues to be discussed in the Congress, offers promise of significant increases in revenue.

STATEMENT

Mr. Chairman, distinguished Members of the Committee, my name is William R. Harris, Vice President and General Manager, Industrial Chemical Division, PPG Industries, (PPG). I sincerely appreciate the opportunity to appear before the Committee to express PPG's views on the Administration's revenue raising proposal, particularly that part which concerns the business energy investment credit.

PPG

PPG is a major manufacturer of glass, chemicals, coatings and resins, and fiber glass products, headquartered in Pittsburgh, Pennsylvania. The company operates 41 major manufacturing and research facilities in 17 states, employing approximately 28,000 people nationwide.

As an industrial manufacturer, for which energy is a substantial portion of operating needs and costs, we have a significant interest in legislation which encourages investments in energy-conserving property. In 1980, PPG consumed about 105 trillion BTU's of energy in the manufacture of its products, down from a 1976 total of 139 trillion BTU's. In 1980, our energy efficiency as a corporation had improved more than 23 percent compared to 1972, while production and sales increased.

PPG has faced essentially the same or greater cost increases for energy over these years as has been experienced by the general public. Energy is a substantial cost item to PPG totaling approximately $187 million in 1981. However, it is not our only cost and represents some seven percent of the company's U.S. sales dollars. Therefore, although energy costs have soared and are expected to increase further, they are still only one important cost item among many. Within a corporation, competition for the capital expenditure dollar for energy saving or other projects must be considered in light of projected economic benefits. Therefore, the blind pursuit of energy conservation for conservation's sake is a luxury PPG, and I suspect most companies, cannot afford in their highly-competitive markets.

While the subject of these hearings is clearly the broad and very complex revenue raising proposal of the Administration, my purpose today is to focus on one small but important part of that package, the business energy tax incentives. PPG believes the elimination of existing energy tax credits is not consistent with the Administration's goals to strengthen the economy, reduce inflation, increase productivity, and stimulate capital formation for further productive investment.

HISTORY OF TAX CREDITS

The use of tax credits as an incentive to stimulate the modernization of industrial processes used by industry is a concept well established in our tax system. The use of tax credits was first approved by Congress as part of the Revenue Act of 1962. In 1962, it was noted that American industry must compete in a world of diminishing trade barriers and growing foreign competition, and that an increase in efficiency and productivity at a rate at least equal to that of other leading industrial nations is in the long run necessary, both from the standpoint of U.S. balance of payments and to improve our standard of living.

To deal with these problems, the objectives of the investment credit were to "encourage modernization and expansion of the Nation's productive facilities and thereby improve the economic potential of the country with a resultant increase in job opportunities and betterment of our competitive position in the world economy." (S. Rept. No. 1881, 87th Cong., 2nd Sess., 1962). These objectives would be realized, it was observed in 1962, by using investment credits to stimulate investment and increase the availability of investment funds. The importance of these goals, and the appropriateness of investment credits for achieving them, are as valid today as they were two decades ago.

ENERGY TAX CREDITS

Congress further recognized the incentive potential of investment credits when it enacted the Energy Tax Act of 1978, to utilize energy investment credits as an incentive to encourage industrial energy conversion and conservation. It realized that the Nation's dependency on foreign energy resources posed a serious threat to our economic well-being and our national security. The Congress rightly perceived that energy conservation would make an important contribution to both reduces U.S. dependence on foreign oil supplies and bring energy supply and demand more into balance.

The concept was clear. Given the incentive, industry would spend more funds sooner to reduce its energy dependence. The emphasis was on more and sooner, for, given the importance of energy supply and the rising cost of energy, there is little doubt that where possible the funds would be spent eventually or facilities would be forced to close. The benefit of spending more sooner, however, was clear to Congress. Energy savings would be realized on an accelerated schedule, thereby reducing oil imports and the budgetary and trade impact of these imports.

Under the legislation, Congress considered three main factors. First, they put a limit on the number and types of expenditures that would qualify for the credits. Secondly, focusing on achieving energy savings quickly, a short time period was imposed for realizing the incentive and, thirdly, they limited the incentive to a relatively conservative 10 percent tax credit. Although the favorable results anticipated by Congress have not been fully realized to date, the wisdom of Congress in enacting these energy tax incentives is also as valid today as it was in 1978.

LACK OF TREASURY ACTION

The 1978 Act provided for 11 specified items of what is called "specially defined energy property" to qualify for the energy tax credit, and for authority for the Secretary of the Treasury to specify additional qualifying property for tax credits by regulations. To our knowledge, the Secretarial authority given by Congress has not been exercised to qualify a single item in this category despite the fact that these provisions are scheduled to expire at the end of 1982. Proposed regulations were not issued concerning the procedures for applying for qualifications as specially defined energy property until January, 1981, over two years after passage of the Energy Tax Act. Public hearings were held in April of that year, but to date no final regulations have been published.

AN EXAMPLE

The Crude Oil Windfall Profits Tax Act of 1980 added "modifications to alumina electrolytic cells" to the list of specifically defined energy property legislatively, after no action was taken by the I.R.S. on an aluminum industry application. Similarly PPG attempted to satisfy the administrative requirements for obtaining a determination of eligibility for energy-saving modifications to its chlor-alkali production, which also uses electrolytic cells. Based on the similarity with alumina electrolytic cells, we had also proceeded with an energy conservation program at one of our chlor-alkali facilities with the expectation that this application would be approved. There has been no response.

Improvements in chlor-alkali electrolytic cells save energy in essentially the same manner as the presently eligible alumina electrolytic cell modifications. These improvements are motivated by energy efficiency. They would not increase the productive capacity of the facility and they are not periodic replacements of cell components. The modernization project PPG has underway at one of its chlorine and caustic soda producing facilities, which uses electricity generated by oil and natural gas, will reduce energy comsumption by some 460,000 barrels of fuel-oil equivalent each year. The cell modification project represents a single expenditure at one plant of approximately $100 million and, if completed, would result in an energy saving estimated at 25 percent of current energy usage.

We have also calculated that the investment and energy saving would fall within the mid-range of eligibility under the "qualified industrial energy efficiency property" (QIEEP) concept contained in Congressman Heftel's bill, H.R. 2640, which is currently pending in the House and its companion bill, S. 750, on which we have testified in the Senate. Without a favorable Treasury Department ruling or legislative action to specifically make eligible these electrolytic cell improvements for a sufficient period of time to qualify for a credit, this project will be denied the energy tax credits which are anticipated when funding for the project was approved by our Company. In addition, a failure to all the energy credit for installation of electrolytic cell improvement technology at other PPG plants, and those of others in the chlor-alkali industry, may well result in these energy conservation investments being abandoned. The chlor-alkali industry is the second largest consumer of electricity in the United States.

CONCLUSION

The argument has been made that the Accelerated Cost Recovery System (ACRS) provisions of the Economic Rocovery Tax Act of last year remove the need for energy tax credits to provide incentives for making energy conservation investments. However, a comparison of the application of ACRS and its predecessor, the Asset Depreciation Range (ADR) capital cost recovery systems to chemical industry machinery and equipment, indicates that no significant improvement in the depreciation or cost recovery incentive is provided by ACRS. The energy tax credit was intended to make energy conservation or conversion investments a little more attractive than other types of investments to those who must make significant investment decisions. This rationale for the energy credit is as applicable today under ACRS as it was under the oil ADR system.

The lack of guidelines as to what qualifies, coupled with the approaching December 31, 1982, deadline, has given industry no real signals for making major energy-saving expenditure decisions. In the competition for investment capital, energy-saving projects are competing with out investment opportunities. Management must receive clear signals on what tax credits will or will not be available in order to make these judgments. We recommend that the credit not be repealed, that the definition of qualified property be expanded, and the expiration date be eliminated or extended.

We believe the intent of Congress, when it enacted the Energy Tax Act of 1978, has not been realized, that continuation of energy tax credits is essential to moving the Nation toward greater energy independence, and that credits complement the overall objectives of strengthening the economy, reducing inflation, increasing productivity, and adding to in-place capital formation efforts. We believe energy tax credits pay for themselves, free up generated capital for further investment, and are significant incentives to encourage industry in total to help move our country toward energy self-sufficiency.

My testimony focuses on one small aspect of the Administration's revenue raising proposal with very significant impact of PPG Industries. However, PPG also realizes the importance of reducing the difference between projected federal revenues and expenditures. We believe of greatest importance, in reducing the projected deficit, are ongoing spending reductions throughout the government. On the side of increasing revenue, we believe close attention should be paid to the broad variety of user fees and excise taxes addressed in the Administration's proposal. In addition, the deregulation of natural gas, which continues to be discussed in the Congress, offers promise of significant increases in revenue.

Mr. ANTHONY. Thank you, Mr. Harris, and other members of the panel.

Mr. Russo, do you have questions?

Mr. RUSSO. Yes, Mr. Chairman.

Mr. Gershowitz, in looking at the chart, if I am to read correctly part 3(c) in which you would receive tax-exempt IDB with appreciation ITC and ETC in the 5-year ACRS benefits, it would cost $15.68 in the first year, disposal cost per ton to the municipality.

Your operating cost is $20 per ton. If I read this right, it seems to me that we are having a negative tax benefit.

My question is, should that be public policy, that there be a negative tax benefit?

Mr. GERSHOWITZ. There really isn't a negative tax benefit. This is a net disposal cost.

The way the typical system would operate, you would have the operating charge which would be levied by the operator and we will use the $20-per-ton number for this.

In addition, we would have the debt service on the facility which, in most cases, would be probably higher than the operating charge, probably 60 to 65 percent of the cost will be the fixed operating cost.

So, the total cost of the system, debt service plus operating cost, is apt to be in the neighborhood of anywhere from $50 to $70 per ton.

From that, we would then subtract the energy credit to arrive at the lower cost, which, in this case, in the worse case, would be the $34.66, and escalating down.

Because of the added tax benefits of the investment tax credit and the accelerated depreciation, the cost structure presented to the community would reflect the annual prorated share of those tax benefits so that the $20 per change that the operator would receive which is perhaps only a third of the total cost to the community, would be more than offset between the energy credits the community would receive and these combination of tax benefits.

So, the net disposal cost to the community itself would get as low as the $15.68 example with the 5-year ACRS.

That is net after all credits, that would include the tax credits as well in this case.

Mr. RUSSO. Thank you.

Mr. ANTHONY. I would like to ask you just a broad question and have each one of the members of the panel address this.

After hearing your testimony, it appears that you are saying that a business decision made in the various areas that you do represent in trying to conserve energy, one of the large factors to be taken into consideration would be the tax consequences of how that business decision would be treated.

Is that a fair assessment of what each of you are saying?

Mr. MIGHDOLL. I think it is a very fair statement, Mr. Chairman. In the case of the recycling segment of it, major corporations have to make decisions well out in front of moving to either use of recycled commodities, as opposed to continuing their present raw material furnished from virgin sources.

Sometimes it needs a different type of facility or revamping of the plant. Or a new plant.

Those decisions are years ahead of the actual work. With the tax credit due to expire this year, as early as 1 year after it was passed in 1978, companies were scraping their heads and saying, will it last.

Of course, they are all sitting tight, waiting to see what happens now so it is essential that that be programed into their thinking.

Mr. ANTHONY. Mr. Zimmer?

Mr. Zimmer. I think that is a fair statement, Mr. Chairman. I guess I would add that one of the key evaluating tools is the rate of return associated with the investment.

Unfortunately, with limited capital and numerous demands on that available capital, decisions are slanted more in the direction of investments that increase production capability over an investment associated with increasing the efficient use of energy.

In that regard, then, the availability of the business energy tax credit could be a definitive quantum in terms of promoting the decision to go with the energy efficiency improvement.

Mr. Anthony. Mr. Gershowitz.

Mr. Gershowitz. Let me make two brief observations, Mr. Chairman.

First, it would be that in the absence of the existing tax benefits available to waste energy systems, I do not think there is an observer of this field in the country who would not concur that waste-to-energy resource recovery will grind to a halt, period.

The other point that I would make—and I think it serves your question so well—if we look at the area of hazardous waste disposal in the United States, an area that uniformly everyone would concur is an area of major concern, while the Resource Conservation and Recovery Act of 1976 addresses hazardous waste disposal within the same authoritative and enabling legislation by definition as solid waste disposal, the Treasury does not recognize hazardous waste disposal facilities as being available for tax-exempt financing while it is—while solid waste disposal facilities are available for tax-exempt financing.

Now, I can think of no area, absolutely no area, where the use of this tax incentive to attract capital is more sorely needed than in the area of new capital deployment for hazardous waste disposal facilities in the United States.

The intent of the legislation is to encompass both solid and hazardous waste disposal as a single issue and so defined in the legislation.

The anomoly in the implementation of tax policy is that IRS has allowed this tax incentive to be available for solid waste, it is unavailable, hazardous waste disposal facilities are financed at the prime rate or higher where solid waste facilities are financed at the tax-exempt rate.

Mr. Anthony. Is that a Treasury ruling or is that legislation?

Mr. Gershowitz. It is Treasury policy.

Under the Resource Conservation Recovery Act, solid waste and hazardous waste are both covered within the same legislation.

Treasury policy does not recognize hazardous waste facilities as qualifying for tax-exempt financing while solid waste does.

I would submit that that is an anomoly that serves for public policy in the United States today.

Mr. Anthony. Treasury policy continues to baffle many of us that try to keep up with it. So we will add that to the list.

Mr. Harris?

Mr. Harris. There are certain investments and modernizations and energy conservation that will be done regardless of the energy tax credit.

But there are other modernizations and energy conservation projects that have to compete with capital for other investments.

We feel that the energy tax credit is necessary in order to stimulate capital going into those type investments so that we do have a consistent energy conservation program.

Mr. ANTHONY. So we could look at stability. If the investment tax credit or the energy tax credit remains on the books and is extended and management sees stability in governmental policy, it would encourage you to go into these energy conservation areas and then it would also help establish what would be considered a national energy policy, is that a fair assessment?

Mr. HARRIS. That's correct.

Mr. MIGHDOLL. Yes.

Mr. ZIMMER. Very much so.

Mr. ANTHONY. Thank you very much for your testimony. You listed things in your testimony, Mr. Zimmer, that I mentioned to previous witnesses I am particularly interested in.

In my home county on cogeneration, we have a deep well extracting the heat and making steam to drive electricity. Monsanto is looking at using the lowest form of its asphalt residue to create steam and to be piped to other industries and, of course, all of our big timber companies are using bark and white wood waste materials.

So I think you have given us very valuable testimony and we thank you very much for your participation.

Mr. Stark, you did come in before we closed the panel.

If you have any questions, certainly we want to make the opportunity available to you and to Mr. Pickle.

Mr. STARK. No, thank you, Mr. Chairman.

Mr. ANTHONY. Our last panel of the day, Independent Petroleum Association of America, represented by Robert E. Vinson, chairman of the tax committee; National Association of Royalty Owners; James L. Stafford, president; Gwynne G. Gazzaway, royalty owner; Vera Barrick, royalty owner, accompanied by the honorable Carl T. Curtis, counsel; Texas Independent Producers and Royalty Owners Association, Thomas D. Coffman, National Energy Policy Committee.

Mr. Pickle, you were seeking recognition earlier, I understand that you have a constituent on the panel and you are recognized at this time.

Mr. PICKLE. Mr. Chairman, I look forward to listening to the testimony of this panel. I particularly want to welcome Mr. Coffman. Tom Coffman is from Austin, Tex., and is one of the most prominent independent driller producers in the State of Texas.

He is a man actually in the field who knows what it is to risk and to venture and to produce. I think we will find his testimony helpful to this committee. I particularly want to welcome him to the committee this morning.

He is also a good friend of our colleague, Mr. Hance, and I want to be sure that is known, since Mr. Hance is not here this morning.

Mr. ANTHONY. Thank you very much, Mr. Pickle.

A special welcome to Mr. Coffman and all the other members of the panel.

We would proceed in the order in which your names were called. So, Mr. Vinson, your testimony will be submitted for the record in whole and you are welcome to proceed as you please.

STATEMENT OF ROBERT E. VINSON, CHAIRMAN, TAX COMMITTEE, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

Mr. VINSON. Thank you very much. I am Robert E. Vinson, I am representing the Independent Petroleum Association of America, which has almost 8,000 members nationwide and some 30 cooperating State and regional associations whose combined membership includes virtually all of the 15,000 independent explorer-producers in the domestic petroleum industry.

In the past, negative policy changes in the tax area have had a devastating effect on domestic petroleum exploration and production.

Consider two examples: The reduction in percentage depletion in 1969 precipitated the two largest drops in exploratory drilling in the history of the industry in 1970 and 1971.

Second, the 1976 provisions subjecting intangible drilling costs to the minimum tax was a major factor in limiting the 1977 increase in exploration and development expenditures by independents to 6 percent, compared to the 71 percent increase the previous year.

So in considering the relationship between the negative tax policy changes and the industry response to these changes, it is important to emphasize that exploration and production activities are extremely sensitive to negative tax changes because such operations are extraordinarily capital intensive.

Another critical point to understand, Mr. Chairman, is that it takes the industry years to recover from these negative tax changes because its operations inherently require long leadtimes.

This brings me to my second major point. A positive economic climate combined with market pricing have yielded substantial energy and economic benefits.

Although the previous up cycle ended 26 long years ago, and this one is just getting started, consider these facts.

In 1980, we set a historical record in drilling and added as much new crude oil reserves as we produced for the first time in 14 years.

In 1981, we again set a drilling record of more than 80,000 wells and there is every reason to believe the reserve additions will be even better when the numbers are in.

We have just about doubled the number of independent explorer producers since the 1973 embargo. Employment in exploration and production has tripled in that same time.

The rig count has risen 140 percent just since 1975 and was 4,530 at yearend.

Independent producers have accounted for 95 percent of the increased drilling since the 1973 embargo, and have consistently reinvested the equivalent of 105 percent of their gross wellhead revenues.

The explosion of oil- and gas-related activities has helped many sectors of the country indirectly and many industries directly, such as steel, which is building new capacity and reviving idle mills just to supply demand for the oil industry tubular goods.

These favorable trends are shown in illustrations attached to my statement.

The domestic petroleum industry is dead set on a course to retain a position of relative energy security for America, if we are not thrown for a loss by new tax roadblocks which aim only at closing a revenue gap and ignore the energy supply consequences.

In spite of these favorable trends, new warning signals that are too recent to analyze completely, call for concern. For example, the price of oil has dropped from nearly $40 per barrel a year ago, to $29.75 per barrel at the present time.

We have stacked more than 800 drilling rigs, or 20 percent, since January 1.

This reverses an uninterrupted increase that began in 1979 and we have never had a comparable decrease in active rig count.

The last thing this industry and our country needs at this time is further uncertainty on tax policy fronts.

We believe that many of the current tax proposals will result in greatly reduced domestic energy production and jeopardize our recent gains.

We have had time only to consult superficially with industry tax experts on the matter of the pending alternative minimum tax.

However, case studies show several negative results including 35 percent curtailment of exploration development expenditures, even without taking into account the reduction from the psychological impact on outside investors who provide a significant portion of funds available for exploration and drilling activity.

Exploratory drilling will be much more severely impacted than development drilling, which means that new or more aggressive companies will be hurt more than less aggressive companies producing existing reserves.

Some have suggested that intangible drilling costs be included within the 5-year accelerated cost recovery system in lieu of the present tax treatment.

There is attached to my statement a chart which illustrates the damaging impact of this proposal. In 1981, for example, if this proposal had been in effect, only 21,000 wells would have been completed as opposed to the actual 55,000 successful wells.

To the extent percentage depletion is still available, it is subject to several limitations.

A taxpayer can utilize percentage depletion only to the extent of 65 percent of his ordinary taxable income, so anyone using percentage depletion will also be paying ordinary income tax.

It provides a significant source of funds used for exploration and drilling activities by independent producers and should be freed of existing limitations, not further penalized.

Changes made last year in the windfall tax, while representing only a very modest part of the total revenue impact of the 1981 act which, incidentally, the impact for our industry was 1½ percent of that total, will provide for incentives for maintaining production from marginal wells as well as adding new reserves and production which our economy needs.

In conclusion, Mr. Chairman, although reasonable men may differ about tax policy questions, the role of the projected deficits and pace of our economic recovery, I think we can all agree on the need to stimulate private investment and economic activity in the country.

I think we can also agree on the need to continue to activate our domestic petroleum industry so we can further reduce our still unacceptable dependence on foreign energy.

Mr. Chairman and members of the committee, we appreciate this opportunity.

Mr. ANTHONY. Thank you, Mr. Vinson.

[The prepared statement follows:]

STATEMENT OF

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

AND

- AMERICAN ASSOCIATION OF PETROLEUM LANDMEN
- ARKOMA BASIN INDEPENDENT GAS PRODUCERS ASSOCIATION
- CALIFORNIA INDEPENDENT PRODUCERS ASSOCIATION
- EASTERN KANSAS OIL AND GAS ASSOCIATION, INC.
- ILLINOIS OIL AND GAS ASSOCIATION
- INDEPENDENT OIL AND GAS ASSOCIATION OF WEST VIRGINIA
- INDEPENDENT OIL PRODUCERS TRI-STATE, INC.
- INDEPENDENT PETROLEUM ASSOCIATION OF MOUNTAIN STATES
- INDEPENDENT PETROLEUM ASSOCIATION OF NEW MEXICO
- INDIANA OIL AND GAS ASSOCIATION
- KANSAS INDEPENDENT OIL AND GAS ASSOCIATION
- KENTUCKY OIL AND GAS ASSOCIATION
- LIAISON COMMITTEE OF COOPERATING OIL AND GAS ASSOCIATIONS
- LOUISIANA LANDOWNERS ASSOCIATION, INC.
- LOUISIANA ASSOCIATION OF INDEPENDENT PRODUCERS AND ROYALTY OWNERS
- MICHIGAN OIL AND GAS ASSOCIATION
- NATIONAL STRIPPER WELL ASSOCIATION
- NEW YORK STATE OIL PRODUCERS ASSOCIATION
- NORTH TEXAS OIL AND GAS ASSOCIATION
- OHIO OIL AND GAS ASSOCIATION
- OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION
- PANHANDLE PRODUCERS AND ROYALTY OWNERS ASSOCIATION
- PENNSYLVANIA GRADE CRUDE OIL ASSOCIATION
- PENNSYLVANIA OIL AND GAS ASSOCIATION
- PERMIAN BASIN PETROLEUM ASSOCIATION
- ROYALTY OWNERS AND INDEPENDENT OIL AND GAS PRODUCERS ASSOCIATION OF ARKANSAS
- TENNESSEE OIL AND GAS ASSOCIATION
- TEXAS INDEPENDENT PRODUCERS AND ROYALTY OWNERS ASSOCIATION
- VIRGINIA OIL AND GAS ASSOCIATION
- WEST CENTRAL TEXAS OIL AND GAS ASSOCIATION

By

Robert E. Vinson

Summary

I. In the past, negative policy changes in the tax area have had a devastating effect on domestic petroleum exploration and production.

Consider two examples:

- The reduction in percentage depletion in 1969 precipitated the two largest drops in exploratory drilling in the history of the industry in 1970-1971.
- The 1976 provision subjecting intangible drilling costs to the minimum tax was a major factor in limiting the 1977 increase in exploration and development expenditures by independents to 6 percent compared to the 71 percent increase the previous year.
- In considering the relationship between the negative tax policy changes and the industry response, it is important to emphasize that exploration and production activities are extremely sensitive to negative tax changes because such operations are extraordinarily capital intensive.
- It takes the industry years to recover from these negative tax changes because it's operations inherently require long lead times.

II. A positive economic climate combined with market pricing have yielded substantial energy and economic benefits.

Although the previous "up" cycle ended 26 long years ago and this one is just getting started, consider these facts:

- In 1980, we set a historical record in drilling and added as much new crude oil to reserves as we produced for the first time in 14 years.
- In 1981, we again set a drilling record of more than 80,000 wells and there is every reason to believe the reserve additions will be even better when the numbers are in.
- We have just about doubled the number of independent explorer-producers since the 1973 embargo.
- Employment in exploration-production has almost tripled in the same time.
- The rig count has risen 140 percent just since 1975 and was 4,530 at year end.
- Independent producers have accounted for 95 percent of the increased drilling since the 1973 embargo and have consistently reinvested the equivalent of 105 percent of their gross wellhead revenues.
- The explosion of oil and gas related activities has helped many sectors of the country indirectly, and many industries such as steel directly which is building new capacity and reviving idle mills just to supply the demand for the oil country tubular goods.

The domestic petroleum industry is dead set on a course to retain a position of relative energy security for America-if we are not thrown for a loss by new tax road blocks which aim only at closing a revenue gap and ignore the energy supply consequences.

III. In spite of these favorable trends, new warning signals that are too recent to analyze completely call for concern.

- The average price of "new" oil has dropped from about $35 a year ago to $29.74 at present.
- We have stacked more than 800 rigs or 20 percent since January 1st. This reverses an uninterrupted increase that began in mid 1979, and we have never had a comparable decrease in the active rig count.

The last thing this industry and our country needs at this time is further uncertainty on the tax policy front.

IV We believe that many of current tax proposals will result in greatly reduced domestic energy production and jeopardize our recent gains.

We have had time only to consult superficially with industry tax experts on the matter of the pending "alternative minimum tax". However, case studies show several negative results.

- A 35% curtailment of exploration-development expenditures, even without taking into account the reduction from the psychological impact on outside investors who provide a significant portion of funds available for exploration and drilling activity.
- Exploratory drilling will be much more severely impacted than development drilling which means that new or more aggressive companies will be hurt more than less aggressive companies producing existing reserves.

Some have suggested that intangible drilling costs should be included with the five year accelerated cost recovery system in lieu of their present tax treatment.

- The attached chart (Chart 9) illustrates the damaging impact of this proposal. In 1981, for example, if this proposal had been in effect, only 21,000 wells would have been completed as opposed to the actual 55,000 successful wells.

V. Although reasonable men may differ on tax policy questions, the role of the projected deficits and the pace of our economic recovery, we can all agree on the need to stimulate private investment and economic activity. We can also agree on the need to continue to activate our domestic petroleum industry so that we can futher reduce our still unacceptable dependence on foreign energy.

Statement

My name is Robert E. Vinson. I am representing the Independent Petroleum Association of America (IPAA), a national organization of independent petroleum explorer-producers, having almost 8,000 members in every producing area in the nation. Together with the thirty unaffiliated state and regional associations which join us in these comments, we represent essentially all of the 15,000 independent oil and gas producers who account for about 90 percent of all the drilling in the United States. We welcome and appreciate this opportunity to express our views on tax policy issues under consideration by this committee.

In recent years, a number of tax changes negatively impacted on domestic petroleum exploration and development and have caused a yoyoing effect on industry expenditures and activity. I will cite only two examples:

(1) Oil and gas depletion was singled out for reduction in 1969, and this action was followed in 1970 and 1971 successively by the two largest drops in exploratory drilling in the history of the industry.

(2) In 1976, exploration and development expenditures by independent producers increased by 71 percent over the previous year, 1975. But in October 1976, Congress subjected intangible drilling costs to the 15 percent minimum tax, and in 1977 exploration/development expenditures by independents increased by only 6 percent from the previous year.

Recognizing that this latter provision impacted most severely on those most vigorously exploring for new petroleum resources, Congress partially corrected the disruptive impact of the minimum tax on IDC's in 1977. Later I will discuss our preliminary conclusions on the impact of the pending "alternative minimum tax" proposal which we believe would more seriously impair exploration/drilling activity than the 1976 provision.

As we know from experience following previous changes in energy tax policy, it can take years for the industry to recover from such changes because oil and gas exploration is a capital intensive activity involving long lead times. The industry is now making solid gains toward significantly reducing dependence on foreign oil. In the past two years, 1980 and 1981, successive records were established in well completions in the United States. In 1980, the industry added new crude oil reserves equivalent to production for the first time in 14 years. We believe when the numbers are in, the year 1981 will have proved to be even better.

Because of the time lag between changes--up or down--in the drilling rate and changes in the production rate, any action now which reduces our exploration and drilling activity will cause a negative impact on domestic oil and gas production later, just about at the time when our economic recovery could least afford it.

Despite the gains stimulated by crude oil decontrol, we must be mindful that the Nation still is importing some 5,000,000 barrels daily of foreign oil. We have a long way to go in restoring relative energy security, and this is no time to create new uncertainty with precipitate new tax changes which are based on revenue considerations alone.

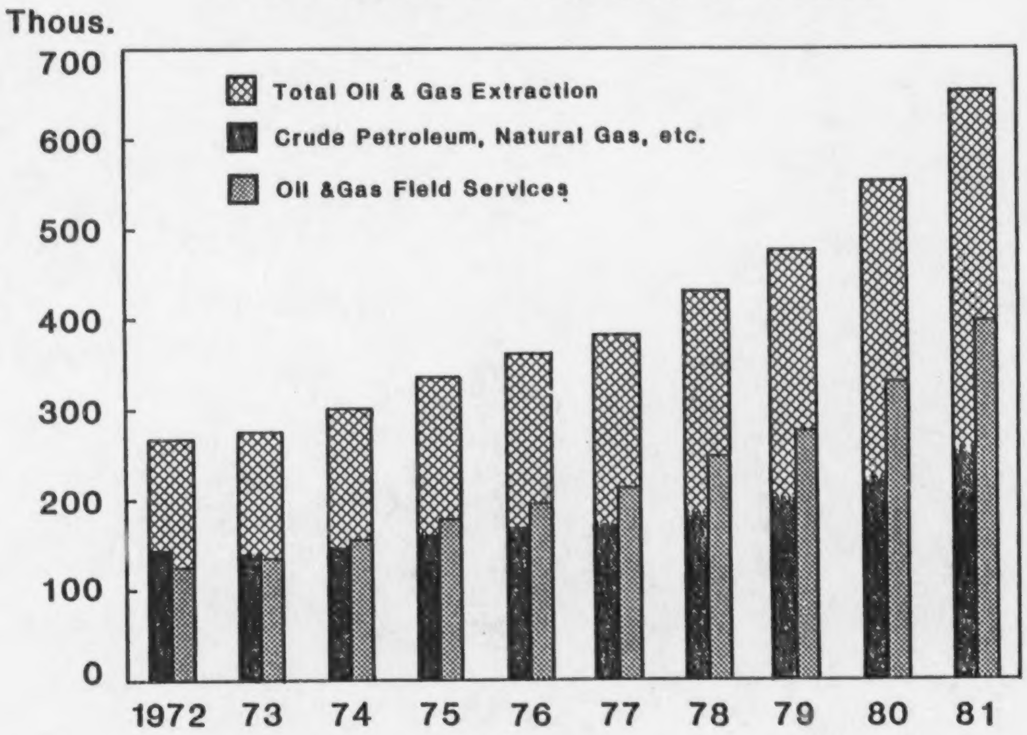
Now, I would like to be more explicit about some of the meaningful gains by the domestic petroleum producing industry.

In my comments I will talk about the exploration-producing segment of our domestic petroleum industry. I will be discussing the benefits to the Nation of our increased activity and how the policies this committee is considering would jeopardize those benefits at a time when we should be consolidating our gains.

Decontrol and higher prices of crude oil have resulted in a booming domestic energy industry. We are resurrecting an industry that was devastated in the 1960's by intolerable economic incentives. Consider the following facts:

- The number of independent producers has increased from 8,300 before the 1973 embargo to more than 15,000 in 1981.
- Employment in the exploration-producing segment of the industry has almost tripled from 1972 through 1982.
- The number of operating rotary rigs for 1981 was 139 percent above the rig count for 1975. At the end of 1981 the rig count was 4,530.
- The number of well completions in 1981 equalled 81,000, which represented an increase of 146 percent over 1974. Independents accounted for 95 percent of this increase with the larger companies in the so-called "Chase Bank Group" drilling the other 5 percent. (Charts 1,2,3)

PETROLEUM EXPLORATION & PRODUCTION EMPLOYEES



Source: Bureau Of Labor Statistics

Chart 1

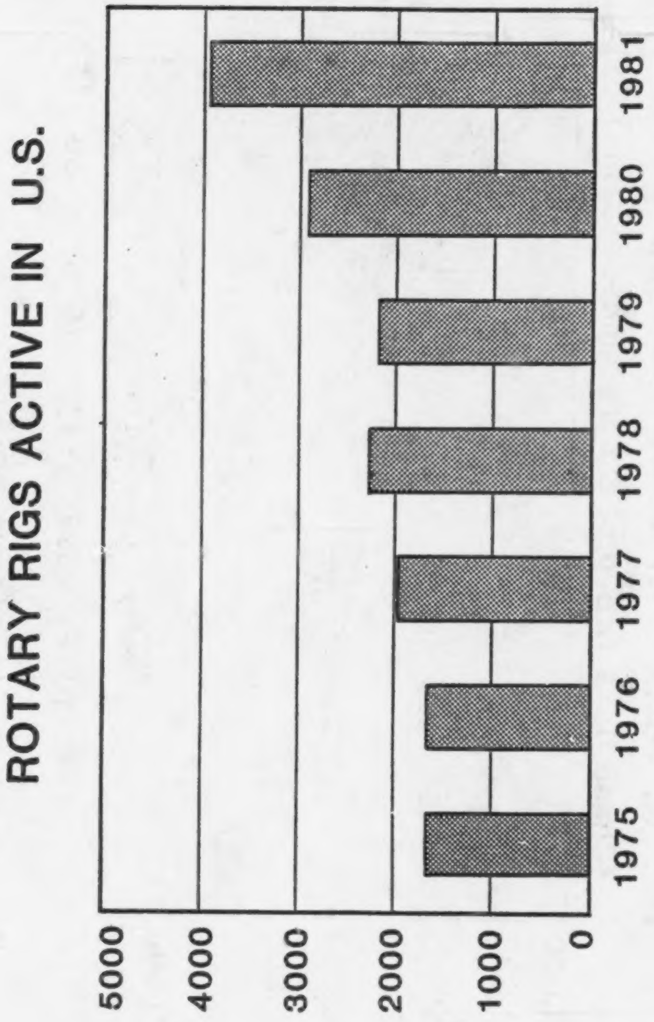
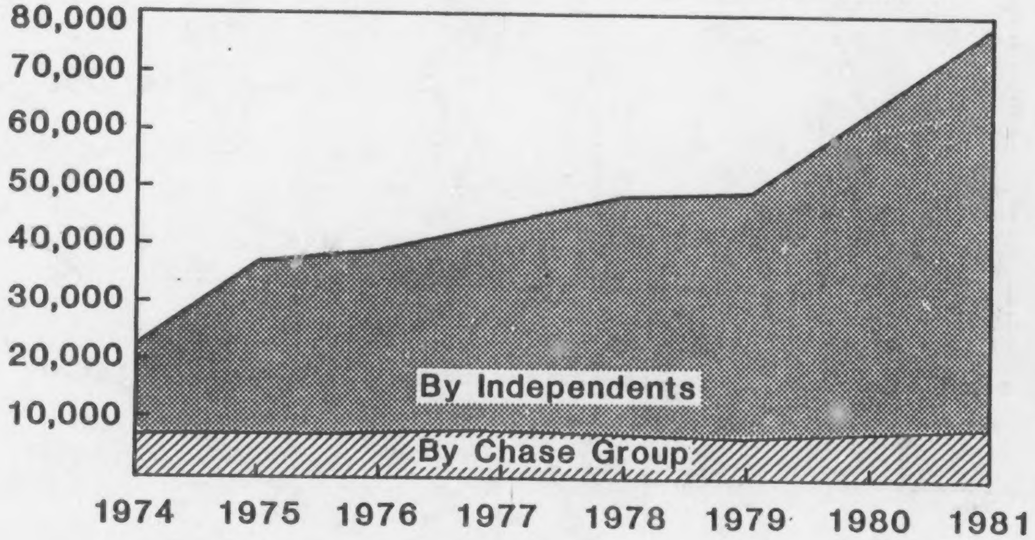

ROTARY RIGS ACTIVE IN U.S.
5000
4000
3000
2000
1000
0
1975
1976
1977
1978
1979
1980
1981

Chart 2

TOTAL WELLS DRILLED FOR OIL &GAS

(Chase Bank Group of Co.'s vs Independents)



Source: Petroleum Information Inc.

Chart 3

But for one of the most onerous taxes ever placed on one industry, the so-called "windfall tax," the record levels cited above would have been much higher.

We think it's important to recognize that at a time when increased investment is so vitally needed in this country, domestic producers have responded to improved prices by continually reinvesting wellhead revenues to find and develop more oil and gas. From 1973 through 1979 (last year for which data is available), expenditures for exploration, development, and production by independents have averaged 105 percent of their gross wellhead revenues for both oil and natural gas.

(Charts 4,5)

PETROLEUM INDUSTRY INCREASES SPENDING TO MATCH RISING WELLHEAD PRICES

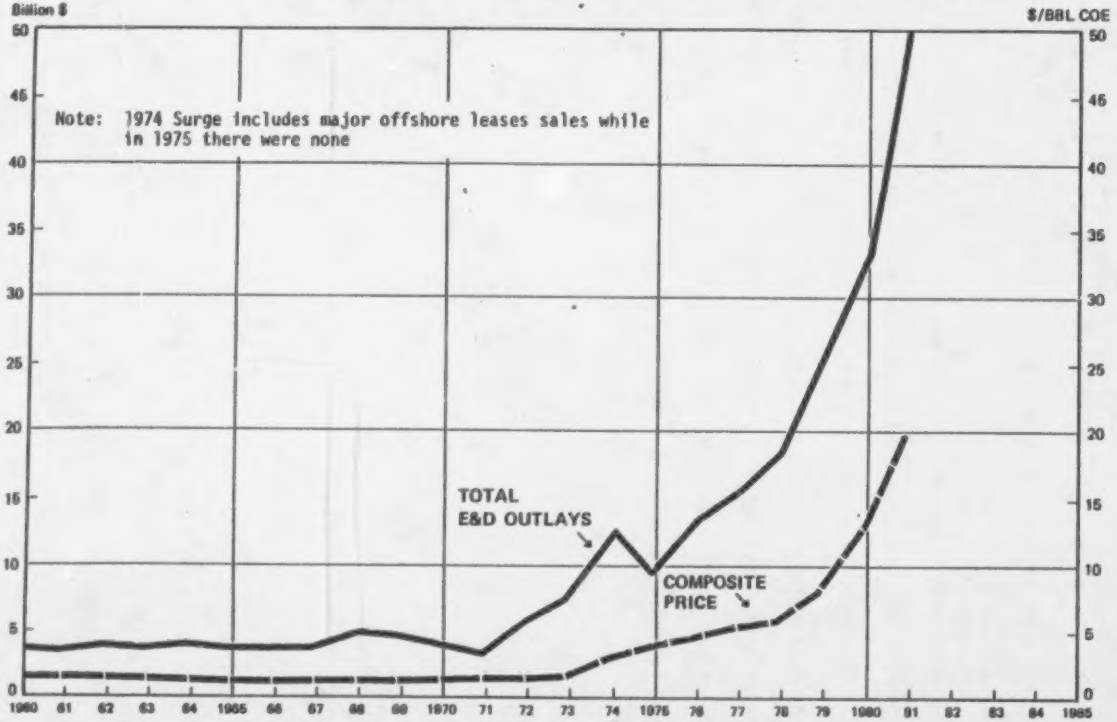
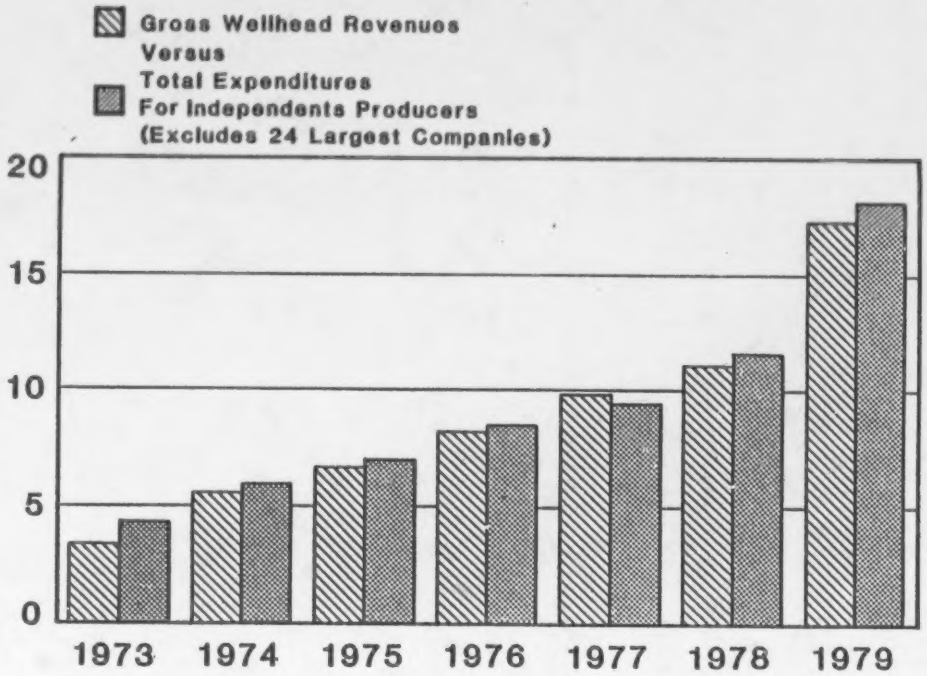


Chart 4

Source: Expenditures 1960-79, Chase Manhattan Bank; 80, 81, IPAAE; Price, IPAA

IPAA CHART
April 1982

INDEPENDENTS MAINTAIN 105% REINVESTMENT RATE



Source: Bureau Of The Census

Chart 5

Critics said these things couldn't be done. They said that we couldn't get the steel, that we couldn't build the rigs, that we couldn't get the employees, and that we didn't have the prospects to drill anyway. It should be clear by now that those who said these things simply had no faith in the innovative skills and resourcefulness of the American people. It should be clear as well that the only thing we were really lacking was adequate economic incentive, because of counterproductive regulatory and tax policies of the Federal government. (Chart 6)

ROTARY RIGS

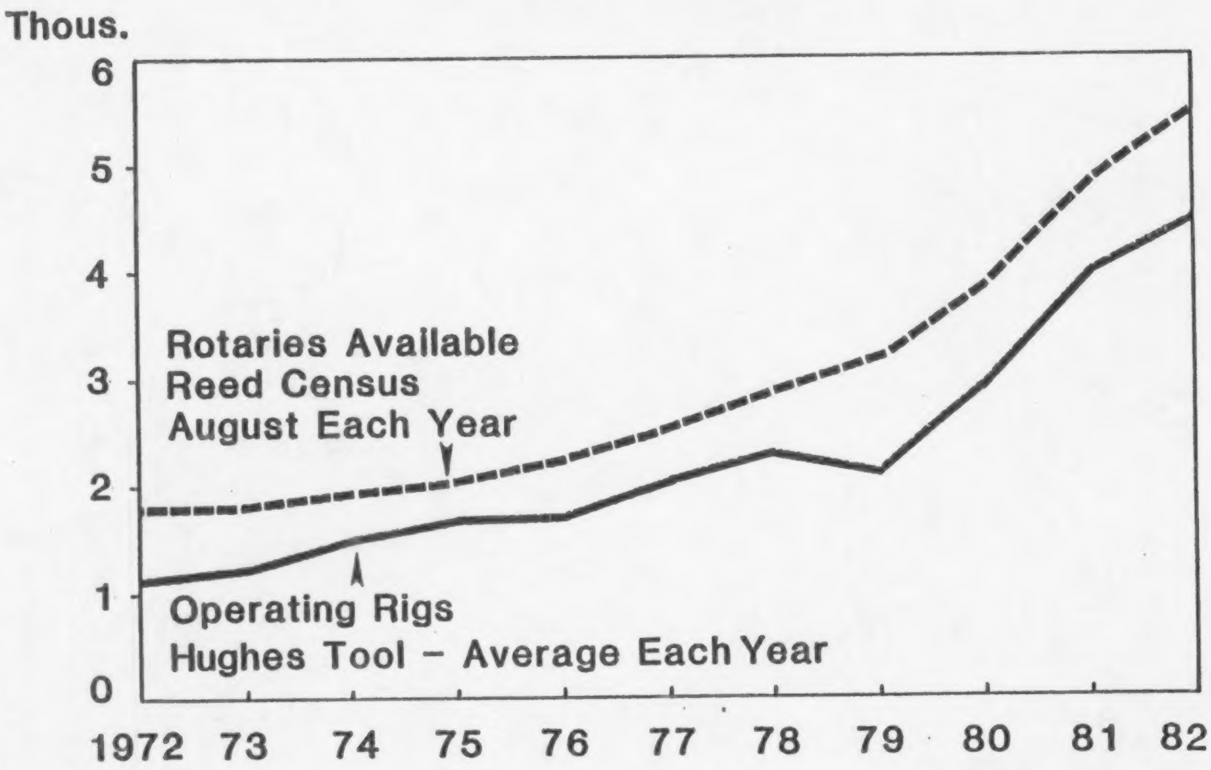
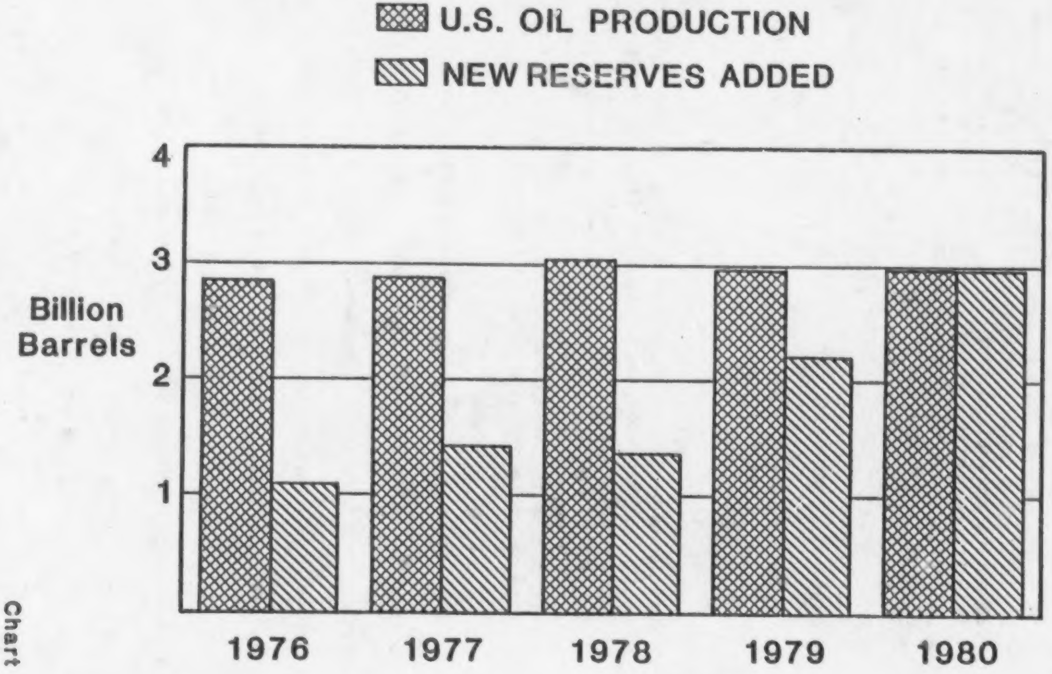


Chart 6

The real question to be asked about this increase in drilling activity and the high levels of investment is "How has the Nation benefited?" We think that the payoff has been dramatic.

- Based on the experience of recent years, for each 1 billion dollars spent on finding and developing crude oil and natural gas, an additional 20,000 barrels of daily productin of crude oil equivalent can be established during the next 10 years. This 20,000 barrels of production will back out 3.9 billion dollars in imports.
- In 1980 the domestic oil industry added crude reserves equivalent to production for the first time since 1966. (Chart 7)

RESERVE ADDITIONS INCREASE TO EQUAL PRODUCTION



Source: API–DOE

(Ex. Prudhoe Bay)

Chart 7

- Increases in drilling activity have also resulted in significant economic benefits to the Nation. Increasing the supply of domestic petroleum has not only benefited those industries that use energy as a significant element in production, but also other industries more directly. For example, the petroleum industry is an important user of steel. During the period from 1976 to 1981 this use doubled. As a matter of fact, in the Washington Post of Sunday March 14, 1982 an article appeared describing how an abandoned steel mill was being renovated to produce oilwell casing. As a result, 500 new jobs will be created in Youngstown, Ohio which has been losing steel-making jobs since 1977. That article is attached.

- Areas of the country that have been hurt by the recession have been helped by extensive new leasing and drilling activity. For example, leasing activity is going on in New England and in the Pacific Northwest, areas long ignored for oil and gas potential. Drilling and production has been significant in areas like Appalachia and the Midwest, especially in states such as Michigan and Ohio that experienced a drilling boom in 1980 and 1981.

Although the industry has made impressive progress, a continuation of these trends is by no means certain. A strong price incentive has had a powerful impact on new investment commitment in the oil industry, including a pronounced surge in drilling activity, accelerated programs in enhanced recovery of known oil reserves, and sharply increased interest in federal lease sales. However, as you've been reading, crude oil prices have been dropping in response to the so-called "oil glut." As a matter of fact, the average price of oil has declined from about $35 in early 1981 to $29.75 today and continues to fall. The impact of this decline is greatly reducing cash flow for producers which in turn will jeopardize future drilling activity. In fact, in the first several months of this year, drilling has already significantly declined (Chart 8).

THE WASHINGTON POST Sunday, March 14, 1982

Hunt Energy Insists Risk In Ohio Is No Pipe Dream

By Peter Behr
Washington Post Staff Writer

By nature and practice, Russell W. Spitz is a risk-taker.

As most of Youngstown, Ohio's steel industry was closing down or moving out, Spitz and his Hunt Energy Co. moved in.

They took over a cavernous, 81-year-old steel mill that had been abandoned by Jones & Laughlin Steel Corp., gutted its insides, and are re-equipping it with modern electric arc furnaces and continuous steel pipe casters. Hunt plans to hire 500 people for the new plant, a helping hand for the Youngstown area, which has lost 11,000 steel-making jobs since 1977.

When completed this fall, the $85-million renovated plant will produce seamless pipe casings to line oil wells, and at the time the project was launched last year that seemed the perfect product.

All through 1981, the demand for the piping, tubing and casing goods used in oil and gas exploration was so heavy suppliers couldn't keep up. Along with Hunt, many large and small steel producers were planning new production facilities to supply the industry, caught up in a drilling boom because of a three-year rise in petroleum prices.

But Hunt figured to be ahead of many of these U.S. competitors. "Our plan is to get on stream as quickly as possible," said Hunt Vice President Robert Williams. Hunt is counting on its modern equipment and a favorable labor contract it is seeking from the United Steelworkers Union to keep its production costs competitive with other U.S. and foreign producers.

Now, however, the road that looked so straight and smooth last fall has developed some jolting bumps.

Oil prices have been falling since the first of the year, thanks to the worldwide surplus of petroleum products; the U.S. drilling surge has cooled off dramatically, and orders for steel pipe have plummeted. After three months of this decline, steel pipe producers now face a huge backlog of inventory, estimated at 5.5 million tons—more than a year's production for domestic steel companies—according to Peter F. Marcus, a steel industry analyst with Paine Webber Mitchell Hutchins Inc.

Quanex, a Texas oil field pipeline manufacturer that was to have had invested $15 million in the Hunt venture for a one-quarter share of the project, pulled out in January.

Despite these reversals, Hunt Energy has not lost faith in its venture, Williams said.

Other financial investors have replaced Quanex, and even without the Texas company, Hunt has contracts now to sell the first two years' production from the plant and those contracts are holding firm.

And Hunt believes it can ride through what it believes will be a temporary slowing in domestic oil and gas drilling. The larger diameter casings it makes are not in such great supply—moreover, casings cannot be reused, while drill tubing is.

"I'm not saying there are no risks. But our feeling is, the more we work with this, the more we feel this mill is a model for the future," he said.

It isn't that risk makes the company shudder. Spitz was a 38-year-old Milwaukee certified public accountant and entrepreneur when he took over the Hunt Valve Co. in 1974. Then it was a backwater manufacturing firm with annual sales of about $2 million, receiving little attention from its parent company, Bellows International.

The financial controls on Hunt then were so tight it couldn't grow, said Williams. There was little research investment or interest in new products. "It was impossible to get any engineering done," Williams said. So the company pumped along with the same product line of industrial valves.

Spitz took the wraps off, Williams said. Instead of waiting for customers' orders, it began designing complex valve systems for steel mills and selling the entire packages, thus eliminating some of their customers' engineering expense. Their list of customers grew to include most of the major steel makers in Japan and Brazil as well as the U.S. industry.

"We upgraded our products—it hadn't been done in 20 years. We built up inventory and reduced delivery time to four weeks [it had been 48 weeks for some products]. It was a risk, but we knew we were serving the steel industry, and we had to have parts and people available."

In the last three years, Hunt invested in computer controls for its cutting and shaping equipment to improve quality and sophisticated computer-aided design terminals.

The results were dramatic, Williams said. Before 1974, they were lucky to sell a dozen of their best quality valves a year. Since 1978, more than 500 have been sold. "We started at $2 million. Today we make $30 million in the valve business alone."

Seeing an eventual slowdown in that business, Hunt turned to pipe production, Williams said, believing that it understood steel-making technology from its experience producing valve systems for the industry.

They saw a bargain in the huge Brier Hill steel plant that was closed by Jones & Laughlin in 1979. "You couldn't put that building up for $20 million today," Williams said. Where that was a basic steel plant, melting ore to make ingots and casting these into shapes, the Hunt process begins with steel scrap that will be dumped from trucks into the tops of two electric arc furnaces.

Molton steel flows from the furnace bottoms and is turned into seamless pipe through a continuous casting process that eliminates several major, costly steps required in the old steel-making technique and improves the quality of the final product as well.

Williams remains confident that steelworkers will agree to work under a fabricators contract rather than the basic steel industry agreement, giving the new plant approximately the same labor costs as a nonunion mill.

If steel prices recover to last year's levels and shipments reach Hunt's goals, the $85 million investment could be recovered in about three years, Williams said. That makes it a risk well worth taking, he says.

ACTIVE ROTARY RIGS
HUGHES TOOL

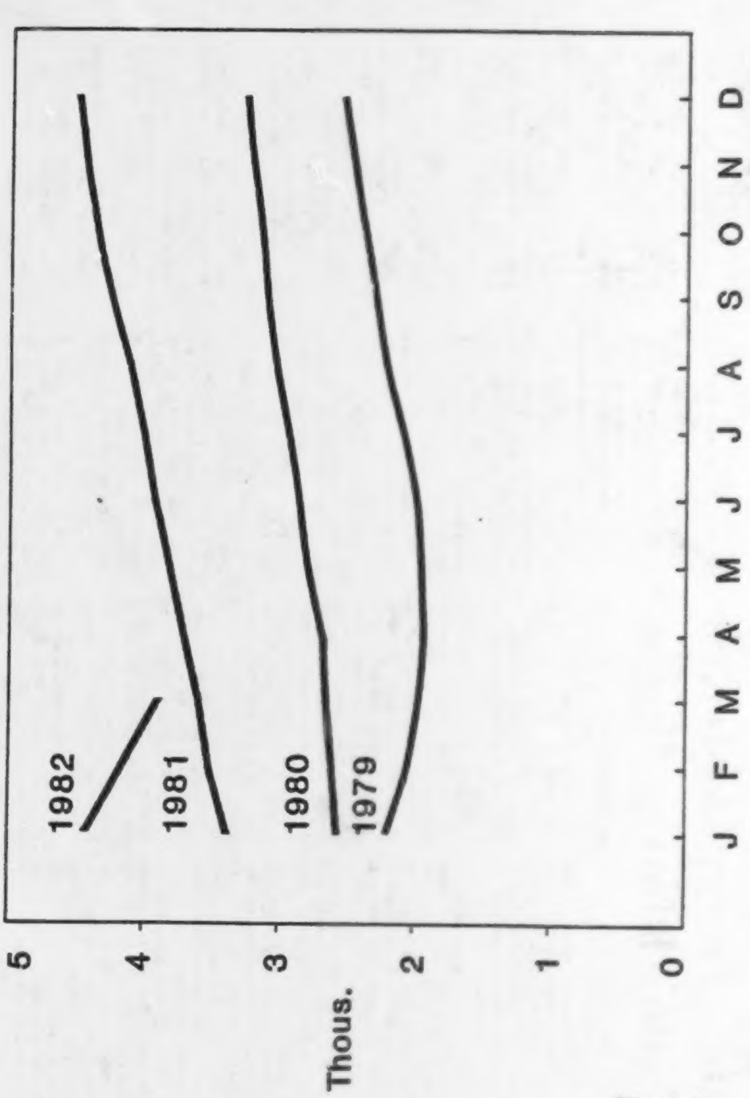


Chart 8

The number of idle drilling rigs today stands at approximately 1,500. The number of idle rigs presently is about the same as the total number of operating rigs in 1974. This drop in the rig count follows an almost uninterrupted increase that began in mid-1979. One of the factors influencing this drop is the uncertainty involved in the budget deficit and tax policy discussions which are on-going in Congress.

MINIMUM TAX TREATMENT OF INTANGIBLE DRILLING COSTS

With this background, I will address the specific proposal concerning the minimum tax and its impact on intangible drilling costs (IDC's).

In general, the proposed application of a minimum tax to IDC's will greatly reduce the funds available for reinvestment in exploration and production as well as encourage abandonment (as dry holes) of many newly drilled marginal wells.

Exploration and drilling for oil and natural gas is a "current cash" business. You don't drill wildcat wells with borrowed money--you must use internally generated cash flow from current sales of oil and gas, augmented with funds from outside investors. Every dollar of income diverted to taxes reduces, by at least a dollar and usually more, expenditures for exploration and drilling.

Even development drilling (wells drilled to develop a field following initial discovery) require internally generated cash and investor funds. Only after sufficient development has taken place so that the reserves "proved up" and actual production from existing wells demonstrate ability to repay a loan can borrowed funds be used to a limited degree for further development.

Intangible drilling and development costs are the single largest element of expenditures for the exploration-producing sector of the petroleum industry. IDC accounts for 40 percent of total outlays for exploration and development excluding lease bonus payments for offshore federal lands. IDC represents 70 percent of the total cost of drilling and equipping a successful onshore well. The other 30 percent, for tangibles such as pumps and wellheads, is capitalized.

Generally, intangible drilling costs are those expenditures incurred for materials and services used in drilling oil and gas wells and preparing them for production but having no salvage value upon abandonment of the well. Costs incurred in drilling a dry hole are always charged to current expense.

Section 263(c) of the Internal Revenue Code, provides that the taxpayer has the option to deduct such costs currently. Under the option, only the holder of a "working" or an "operating" interest (i.e., the interest which is burdened with the risks and costs of developing and operating the property) may currently deduct IDC's. Moreover, the election to deduct IDC's must be made by the taxpayer for the first taxable year in which such costs are incurred and is binding for all subsequent years.

The present treatment of IDC's for income tax purposes was first made available by administrative ruling in connection with the Revenue Act of 1916. T.D. 2447, issued February 8, 1917, reads as follows:

> The incidental expenses of drilling wells, that is, such expenses as are paid for wages, fuel, repairs, etc., which do not necessarily enter into and form a part of the capital invested or property account, may, at the option of the individual or corporation owning and operating the property, be charged to property account subject to depreciation or be deducted from gross income as an operating expense.

Furthermore, the Revenue Acts of 1918 and 1921 implicitly indicate that Congress considered IDC's to be deductible. (Revenue Act of 1918, Sec. 214(a)(1); Revenue Act of 1921, Sec. 214(a)(1)).

Although accounting practices and theories may have changed over the years, the policy to develop our Nation's mineral resources still supports the need for rapid recovery of IDC's for tax purposes. The element of high risk is still present inasmuch as oil and gas deposits have become even more difficult to find. The costs of drilling have escalated. Greater logistical and technological problems are encountered today as the industry must drill deeper and drill in more hostile offshore and frontier environments.

IDC's As An Item of "Tax Preference"

Under present law, the amount by which the "Excess IDC's" exceed the net income from oil and gas properties during the year is a so-called "tax preference" item for individuals. (I.R.C. Sec. 57 (a)(1)) "Excess IDC's" are deductible IDC's incurred during the taxable year less the amount, if any, that would have been deductible in the same year if the taxpayer had amortized the expenses for that year over 120 months beginnning with the month of first production (or, if the taxpayer so elects, less the amount of cost depletion that would have been deductible rather than the 120-month amortization). Since only the first year's allowance for cost recovery is recognized for minimum tax purposes, the amount of the IDC preference is substantially overstated. The IDC tax preference under current law, however, does not apply to corporations with the exception of personal holding companies and Subchapter S corporations.

Because operating costs, overhead, and other taxes are relatively fixed expenses beyond the control of the producer, the only area of planning future expenditures where significant discretion exists is with regard to exploration and drilling budgets. Consequently, this activity is hypersensitive to any changes in tax treatment. The most cursory consideration would indicate that, at the very least, increasing tax liability of explorer-producers would result in a corresponding decrease in exploration and drilling activity. Experience bears this out. In 1969 the statutory rate of percentage depletion for oil and gas was reduced from 27 1/2 percent to 22 percent or a reduction of 20 percent. The following year, 1970, exploratory drilling in the U.S. dropped

21 percent, the biggest drop in a single year in the history of the petroleum industry. In 1971, a further 10 percent decline in exploration drilling was experienced. Fortunately, the fall off in exploratory effort was moderated by minor price increases.

In October 1975, intangible drilling costs for individuals were subjected to the present minimum tax provision. Fortunately, prices for oil and natural gas were increasing which significantly softened the blow, but even so the operating rig count declined sharply throughout the first half of 1976 to a level previously attained in mid-1974. Once again the victim was exploratory drilling which was esentially at the same level of the previous year although there was a rise of over 2,300 in total wells drilled.

It is significant that subjecting intangible drilling costs to negative tax treatment will impact most heavily on newer, and the more aggressive companies actively engaged in development of new oil and gas reserves, in contrast to less aggressive companies which are producing existing reserves. New entrants into the exploration-development industry are critical to our continued progress toward energy independence. For many years the ratio of successful well completions has averaged 6.8 per active operator. Consequently, the significant increase in number of successful well completions is directly related to the increase in active operators of record: i.e., the number of new entrants into the business. The number of operators of record increased from 4,793 in 1974 to an estimated 9,600 in 1981.

As in the past, if IDC is subjected to additional negative tax treatment, exploratory drilling likely would be impacted much more severely than development drilling. Producers are contractually obligated to owners of the mineral interest (royalty owners) to fully develop a lease once a successful discovery has occured. Consequently there is less discretion in drilling of development wells than exploratory wells.

Because the minimum tax affects only producing wells and not dry holes, it would encourage the abandonment as dry holes of newly drilled wells which if completed to produce, would be economically marginal. Many new wells are marginal from the first day of production and this negative tax treatment would result in loss of potential reserves and needed production.

While it is impossible to accurately measure the impact that the proposed negative tax treatment of intangible drilling costs would have, there are ways to develop approximations. IPAA requested members of its Tax Committee to voluntarily develop case histories applying the proposed alternative tax treatment of IDC to actual producer tax records for the last taxable year. While the results vary considerably depending upon whether the taxpayer had substantial income from existing oil and gas production or was a new entrant without substantial existing production, the results indicate a resulting reduction in drilling expenditures on the order of 35 percent. This does not take into account the reduction from the psychological impact on outside investors who provide a significant portion of funds available for exploration and drilling activity.

The following example illustrates the impact:

ILLUSTRATION OF ALTERNATIVE MINIMUM TAX

TAX COMPUTATION ON 1981 ACTUAL RESULTS - EXISTING LAW

Income before IDC expenditure	$879,040
IDC deduction	740,456
Taxable income	$138,584
Income tax (corporate rates)	$ 44,498
Less investment tax credit	30,574
Net income tax paid	$ 13,924

TAX COMPUTATION ON 1981 ACTUAL RESULTS - PROPOSED ALTERNATIVE MINIMUM TAX

[1] Taxable income per above	$138,584
Add back IDC deduction	740,456
Alternative taxable income	$879,040
Alternative minimum tax at 15%	$131,856
Increase in tax burden ($131,856 - $13,924)	$117,932

Effectively, the expenditure of $256,374 in IDC would result in no positive income tax benefit, but instead create $117,932 of additional tax liability (256,374 x .46 = 117,932).

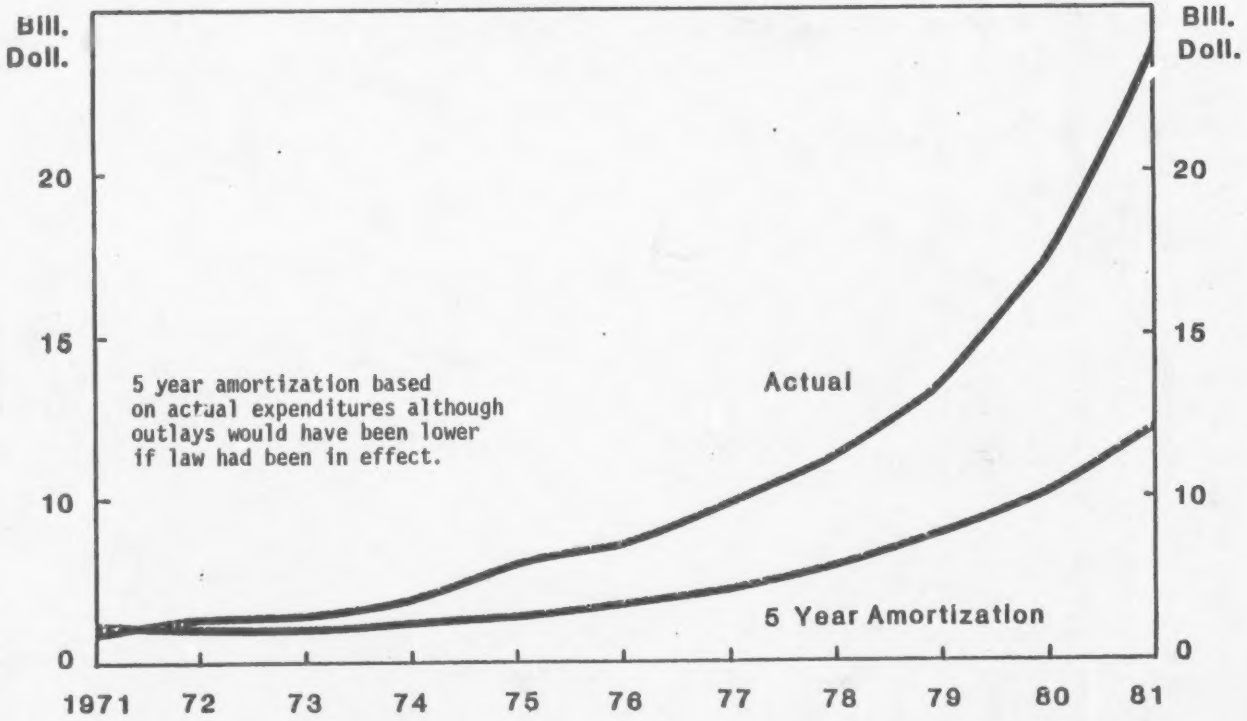
1/ If percentage depletion had been utilized, the excess above cost depletion would be subject to the same "add back" treatment.

Some have recently suggested that intangible drilling costs be included within the present 5 year ACRS treatment. A comparison of (1)(a) expenditures for and (b) the number of successful oil and gas wells completed each year for the period 1971 through 1981 with (2)(a) expenditures for and (b) the number of wells which could have been completed under 5 year ACRS treatment of IDC is very revealing. In 1981, for example, some 55,500 successful wells were actually completed compared with only 21,000 which could have been completed under the ACRS treatment. The impact on our domestic energy supply situation would be very damaging.

(Charts 9 & 10)

INTANGIBLE DRILLING COSTS

ACTUAL EXPENDITURES VS. REDUCED SPENDING IF IDC SUBJECTED TO 5 YEAR ACRS

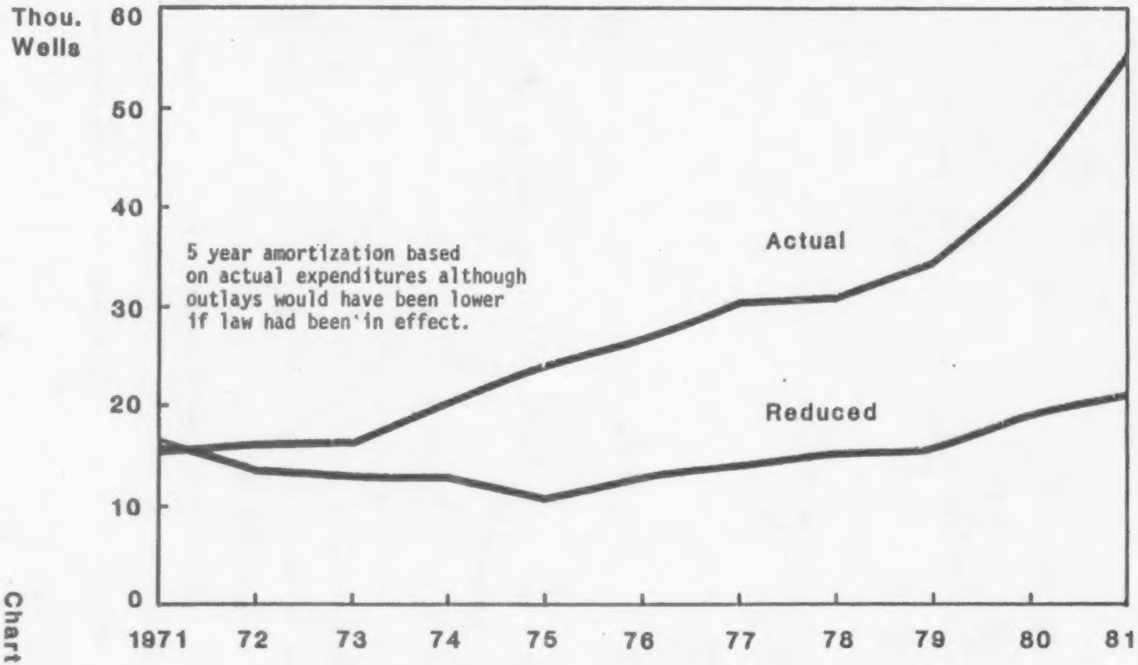


5 year amortization based on actual expenditures although outlays would have been lower if law had been in effect.

Chart 9

SUCCESSFUL OIL & GAS WELL COMPLETIONS

ACTUAL COMPLETIONS VS. REDUCED SUCCESS IF IDC SUBJECTED TO 5 YEAR ACRS



5 year amortization based on actual expenditures although outlays would have been lower if law had been in effect.

Chart 10

Whereas, in 1980 for the first time in fourteen years, new reserves added equalled actual production for that year, it is probable that both domestic production and reserve additions would have continued to significantly decline requiring the importation of substantially more foreign oil, at minimum. Had this situation existed, in all probability there would today not be a glut of crude oil on the world market, and crude oil prices would not have declined approximately 20 percent from the levels of one year ago. Indeed, they probably would now be much higher than last year. Our balance of payments, trade deficits, and budget deficits would be substantially greater than they presently are. The prospects for economic recovery generally would be severely hampered by our continued strong dependence on imported oil which would be continuing to increase in price.

Of all the preference items subject to the existing minimum tax or suggested for inclusion in the new alternative minimum tax, intangible drilling costs and mining exploration and development costs are clearly distinguishable from the others. These items are not so-called "artificial accounting losses" related to capital investments typically made in highly leveraged transactions utilizing borrowed funds and resulting in the creation of tangible assets having a useful life much longer than the period allowed for amortization. IDC requires the direct investment of whole dollars derived from current internally generated cash flow or outside investor venture funds. For the typical oil and gas explorer-producer, the expenditure of IDC must be repeated in a never ending cycle in order to remain in business.

Negative tax treatment of intangible drilling costs would be self defeating in that it would result in an ever decreasing level of expenditures reducing both the direct revenues anticipated from the minimum tax and ordinary income taxes which would decline due to further reduction in income from oil and gas production.

Minimum Tax Treatment of Percentage Depletion

The concept of depletion has been part of the tax code since adoption of the 16th Amendment in 1913. It is the means provided in the tax code to rrecognize consumption of a physical asset as it is removed or produced from the ground. The present mechanism of percentage depletion was adopted in 1926 for crude oil and natural gas, together with some 105 other extractive minerals after the Department of Treasury and taxpayers agreed that the previous "discovery value" method could not be reasonably administered. Present law provides that as minerals are produced and sold, a specified percentage of the proceeds of sale is considered as a return of capital and deducted from gross income. Since 1975, percentage depletion for crude oil and natural gas has been available only to independent producers and royalty owners.

This represents one of the most important sources of cash flow to finance new exploration and drilling activities. However, there are several limitations and restrictions, mostly added since 1968, which significantly reduce its effectivness as a capital generation tool. These limitations are:

1) For each producing property the amount of percentage depletion cannot exceed 50 percent of the annual net income from that property;

2) For each taxpayer, the total percentage depletion from all properties cannot exceed 65 percent of that person's taxable income;

3) Percentage depletion in excess of cost depletion is subject to the 15 percent add on "minimum tax" penalty;

4) Percentage depletion is available on not more than 1,000 BPD of crude oil or natural gas equivalent;

5) For oil and natural gas alone out of the 105 minerals eligible for depletion, the applicable rate — 27 1/2 percent until 1969 — is being reduced in steps from 22 percent in 1980 to 15 percent in 1984 and thereafter;

6) When a producing property is sold or otherwise transferred (except in very limited "paper" transactions) production therefrom loses eligibility for percentage depletion.

By its very nature, changes in percentage depletion have a magnified impact on cash flow. Consequently, as demonstrated above, the level of domestic exploration and drilling activity has reacted very quickly to reductions in the effectiveness of percentage depletion. Therefore, subjecting percentage depletion to the alternative minimum tax would be counterproductive.

WINDFALL TAX CHANGES

Last year Congress made some very modest changes in the crude oil excise tax. The news media, and even some in Congress, have characterized these changes as representing a major portion of the revenues affected by the Economic Recovery Tax Act of 1981. In fact, even assuming the overly generous revenue impact projected (half of which is specifically for royalty owners), the energy provision revenues represent only 1.6 percent of the overall total revenue projections through 1986 of the provisions of the 1981 Act. The energy provisions will actually have a much less significant impact than estimated because of the use of unrealistic crude oil price projections. The revenue projections assumed wellhead prices of over $41 a barrel for 1981, increasing to almost $60 in 1985. In fact, the average wellhead price for 1981 was $31.90 and has since declined to $29.75 and is still falling. Consequently, the actual revenue impact on revenue will be several billion dollars less than estimated. However, the positive benefits in maintaining the productive life of existing wells and encouraging development of new reserves and production are very real. As stated earlier, each additional one billion dollars which producers can invest in exploration and development will bring on 20,000 barrels of daily production of oil equivalent and backs out 3.9 billion dollars of imported oil.

Imposition of the windfall tax on stripper well production, which had been selling at market price for several years, had the same effect as a substantial price rollback. Because stripper wells are economically marginal they are very sensitive to either price or tax changes. To compound the impact of the recent price decline of almost $10 per barrel by either repealing the windfall tax exemption or subjecting stripper wells to a new minimum tax on IDC would cause a new flood of abandonments and reduce overall production.

(Chart 11)

STRIPPER WELLS

PRICE INCREASES KEEP WELLS PRODUCING – REDUCE ABANDONMENTS

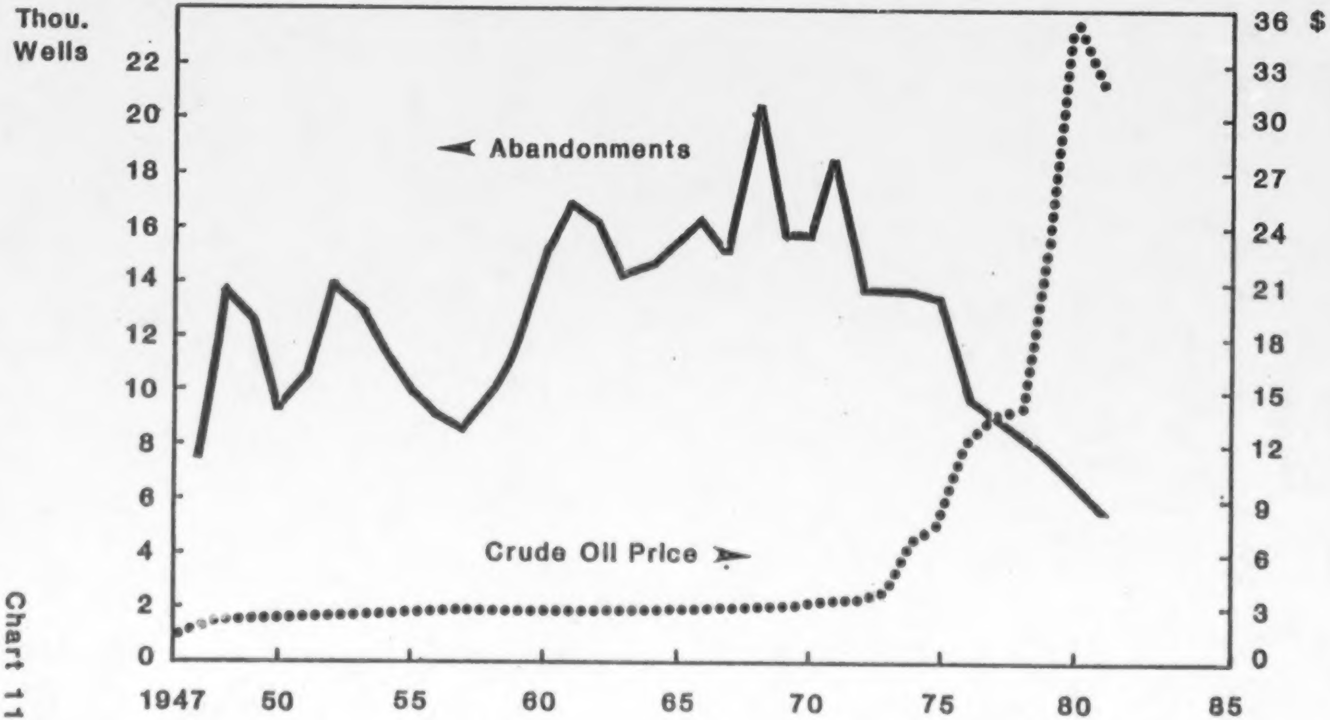


Chart 11

The domestic petroleum industry already bears a significant tax burden and has been repeatedly singled out for punitive treatment on several occasions in recent years. In 1969, the statutory rate for percentage depletion of all producers was cut by 20 percent. In 1975, percentage depletion was eliminated completely for a majority of domestic oil and gas production and further significantly reduced for that production remaining eligible for depletion. In 1976, intangible drilling costs for individual taxpayers was made subject to minimum tax, and in 1980, domestic crude oil production was subjected to the so-called "windfall profit tax." In 1981 the domestic petroleum industry paid an estimated 58 billion dollars in federal, state, and local taxes and royalties, and this does not include the tens of billions of dollars in income, real estate, and other taxes paid by 1.2 million industry employees, 2 million royalty owners, thousands of investors, and more than 15 million shareholders of petroleum companies.

If in fact, tax policy is a key element of overall economic policy, then it would appear that even the thought of increasing taxes on anyone at this time is counter to the conventional wisdom of economic conservatives and liberals alike.

When the economy is in recession is the worst time to increase taxes. In fact, if there ever is a justifiable time for federal deficit spending, it is in a time of economic recession. During periods of recession, federal spending for welfare and unemployment benefits usually rise temporarily, and to the extent that non-essential government spending cannot be cut to make room for these increased outlays, there is some justification for short term government borrowing. To increase taxes at such a time, is to take revenues from the private sector which are essential to recovery from the recession.

Thus, in spite of our concern over the projected 1983 deficit, if we do anything other than to focus on trying to make further cuts in wasteful spending, we are likely to deepen and lengthen the recession.

The problem we face today is particularly frustrating because of what we have done over the past 30 years — run up deficits during good economic times. Budgets should be surplus and balanced in good times, so deficits can be managed in slow times like the present.

An increase in taxes now would reflect an effort to correct past sins more than an effort to confront today's economic situation. Now is the time for another round of budget cuts, not another round of tax increases.

For example, in CBO projections published March 30, 1982, Gross National Product is anticipated to increase at a rate below expected budget outlays. Projected spending of $963.1 billion in 1985 represents a 46.5 percent increase from 1981, just 4 years. Similar increases in the following two 5-year periods would mean federal budget outlays of $2.67 trillion, by 1995.

Judged by any yardstick, such spending expectations depict a government out of control. Such outlays would strangle the economy and assure a chronic stagflation with all its grisly symptoms - unemployment, recession, inflation and runaway interest rates.

Conclusion

For at least the past decade the domestic petroleum industry, especially independent producers, have demonstrated a remarkable propensity to reinvest in new exploration, drilling and development activity funds equal to their gross wellhead revenues. These amounts, rolled over and multiplied throughout our economy—providing needed jobs, developing additional domestic energy production and reduce our dependence on high cost insecure foreign oil producers and improving national security—will provide much greater revenue to the federal treasury (and state and local treasuries) than would siphoning the "cream" off the top directly to the government. For the sake of increased energy self sufficiency and an improved economy, do not subject domestic oil and gas production to any further crippling blows.

Mr. ANTHONY. Mr. Coffman.

STATEMENT OF THOMAS D. COFFMAN, VICE CHAIRMAN, NATIONAL ENERGY POLICY COMMITTEE, TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS ASSOCIATION, AUSTIN, TEX.

Mr. COFFMAN. My name is Tom Coffman. I appreciate the comments Mr. Pickle had to say. I appreciate those kind words.

I am here on behalf of the Texas Independent Producers & Royalty Owners Association [TIPRO].

I am vice chairman for taxation of the association's national energy policy committee. TIPRO is composed of 5,200 members who have petroleum interests in Texas.

Our concern in this hearing is directed to the design of the alternate minimum tax proposal which would require corporations to pay a 15-percent levy on an expanded tax base.

Although we understand the country's need for increased tax revenue, we do not believe that the proposal is in the Nation's best interest.

As independent oil and gas producers, we are specifically concerned by the inclusion in the tax base of the excess of percentage depletion over the adjusted basis of mineral properties and the excess of intangible drilling costs [IDC's] over straight line, 10-year amortization of such costs.

Many independents are incorporated for exploration and development purposes and rely directly on percentage depletion and expensing of IDC's to maintain current expansion of domestic drilling activity.

Without this expansion in activity, the Nation would be forced to rely more on insecure, expensive oil imports.

In 1976, independents who operate on an individual basis were burdened with similar limitations regarding their minimum tax requirements.

However, it was soon discovered that this discriminatory treatment of individuals could cause a decline of 20 to 30 percent in domestic drilling rates.[1]

Ameliorating legislation in the following 3 years eased the burden on individual independents by lessening the IDC preference element in the minimum tax structure.

While independent operators have learned to live with this version of the tax on IDC's, there is little doubt that any diminution of the IDC expensing incentive and percentage depletion incentive would result in less domestic drilling. The reduction would be especially severe where completions of stripper wells and other marginal properties are concerned.

Independents drill virtually 90 percent of the Nation's oil and gas wells and have, since 1975, spent some 105 percent of what they earn at the wellhead in oil and gas operations. Revenue at the wellhead is the primary source of their own capital.

Such a tax would result in reduction of domestic exploration and development of petroleum which can only aggravate unemployment and the Nation's balance-of-trade deficits.

---

[1] Remarks of Senator Bentsen, 123 Congressional Record No. 71 (95th Congress, 1st sess., Apr. 28, 1977.)

In our own case, in 1978 we had three employees. Today we have over 180 employees. I think we are an example of what can happen when, given the opportunity to participate with free enterprise and attack unemployment problems.

Congressional attacks on tax incentives for drilling also constitute poor timing.

Crude oil prices have declined in excess of 20 percent within the past year, and many experts agree that the end of the drop is not yet in sight.

One of the immediate consequences of this is a sharp reduction in domestic drilling activity. Although imports are currently at a relatively low level, reduced drilling can only lead to the need for more imports when a vibrant economy generates a greater need for petroleum products in the future.

Reduction or elimination of tax incentives for drilling would only worsen the situation.

We feel that these negative effects are a sufficient argument against including either IDC expensing or percentage depletion incentives in the minimum tax structure.

In addition, however, we believe that including IDC's would be unfair and contrary to the theory behind a "minimum tax."

As we understand it, a minimum tax is generally imposed only on "artificial" losses which are deductions from income but have not required a direct cash outlay.

Taxation of legitimately paid expenses, however, is contrary to this objective. Such taxation does not further the purpose of a minimum tax—which is to insure that those who escape taxes because of "artificial" deductions will nevertheless pay a substitute minimum tax.

There is no justification for taxing corporate IDC's without regard to their connection with oil and gas exploration.

Where individuals are concerned, the focus of the minimum tax is at least limited to IDC deductions which are not linked with oil and gas income. Independents operating as corporations deserve equal treatment.

A few moments ago, I referred to the threat of an international collapse in crude prices. This, combined with the Nation's need for revenue to cope with budgetary deficits, suggests that the time may have come to initiate a substantial tariff on imported oil and products.

In one stroke, such a move would serve the Nation's security by encouraging maximization of domestic energy, raising considerable Federal revenue, and encouraging continued conservation of energy by American consumers.

Members of this committee are probably aware that windfall tax revenue declines some $1.4 billion for every $1 drop in the domestic crude price. This could be a substantial loss to the Government should crude prices continue to edge toward the $25 per barrel range.

This approach would not result in prices to the American consumer higher than what he experienced as recently as December 1981.

Furthermore, it would provide "energy" revenue for the Nation's needs without endangering the vital function of domestic drilling operations. Conservation objectives would be served, and alternate fuel development would not be devastated as will otherwise be the case.

I thank you for this opportunity to be heard.

Mr. ANTHONY. Thank you, Mr. Coffman.

[The prepared statement follows:]

STATEMENT OF THOMAS D. COFFMAN, VICE CHAIRMAN, NATIONAL ENERGY POLICY COMMITTEE, TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS ASSOCIATION, AUSTIN, TEX.

Mr. Chairman and members of the committee, my name is Tom Coffman, independent petroleum producer from Austin, Texas, and I appear here today on behalf of L. Frank Pitts, president of the Texas Independent Producers and Royalty Owners Association (TIPRO). I am vice chairman for taxation of the Association's National Energy Policy Committee. TIPRO is composed of 5,200 members who have petroleum interests in Texas.

Our concern in this hearing is directed to the design of the Alternate Minimum Tax Proposal (AMT) which would require corporations to pay a 15 percent levy on an expanded tax base. Although we understand the country's need for increased tax revenue, we do not believe that the proposal is in the nation's best interest.

As independent oil and gas producers, we are specifically concerned by the inclusion in the tax base of the excess of percentage depletion over the adjusted basis of mineral properties and the excess of intangible drilling costs (IDCs) over straight line, 10-year amortization of such costs. Many independents are incorporated for exploration and development purposes and rely directly on percentage depletion and expensing of IDCs to maintain current expansion of domestic drilling activity. Without this expansion in activity, the nation would be forced to rely more on insecure, expensive oil imports.

In 1976, independents who operate on an individual basis were burdened with similar limitations regarding their minimum tax requirements. However, it was soon discovered that this discriminatory treatment of individuals could cause a decline of 20 to 30 percent in domestic drilling rates. [Remarks of Senator Bentsen, 123 Congressional Record no. 71 (95th Cong., 1st Sess., Apr. 28, 1977).]

Surveys in 1975 supported the contention that domestic drilling would decline by one-third if independents were forced to capitalize IDCs. Ameliorating legislation in the following three years eased the burden on individual independents by lessening the IDC preference element in the minimum tax structure. This was done, in essence, by reducing their IDC preference item on a property-by-property basis by their net oil and gas income as defined in the law. IDC expenditures on properties which do not produce were not charged a minimum tax.

While independent operators have learned to live with this version of the tax on IDCs, there is little doubt that any diminution of the IDC expensing incentive and percentage depletion incentive would result in less domestic drilling. The reduction would be especially severe where completions of stripper wells and other marginal properties are concerned. Independents drill virtually 90 percent of the nation's oil and gas wells and have, since 1975, spent some 105 percent of what they earn at the wellhead in oil and gas operations. Revenue at the wellhead is the primary source of their own capital. Thus, the less they receive, the less they drill.

The negative effects of such a result are worth dwelling on. Nothing could be more self-defeating than to drain away our capacity for developing energy at the very time the nation is trying to cope with economic decline. Reduction in domestic exploration and development of petroleum can only aggravate unemployment trends and the nation's balance-of-trade deficits. This is so because the country would be forced to turn to imports more and more to meet the demand for energy. Furthermore, it is conceivable that sharp declines in domestic drilling combined with an international crisis could eventually cause severe shortages similar to those experienced during the last decade. Such an experience would only lead to another devastating round of high prices and inflation in the years ahead.

New Congressional attacks on tax incentives for drilling also constitute poor timing. Crude oil prices have declined in excess of 20 percent within the past year, and many experts agree that the end of the drop is not yet in sight. One of the immediate consequences of this is a sharp reduction in domestic drilling activity. Although imports are currently at a relatively low level, reduced drilling can only lead to the need for more imports when a vibrant economy generates a greater need for petroleum products. Reduction or elimination of tax incentives for drilling would only worsen the situation.

We feel that these negative effects are a sufficient argument against including either IDC expensing or percentage depletion incentives in the minimum tax structure. In addition, however, we believe that including IDCs would be unfair and contrary to the theory behind a "minimum tax."

A typical example of how adverse the inclusion of IDC expensing in the minimum tax structure could be is that of the independent who is covered by the minimum tax and spends $300,000 to "frac" a well. Under a 15 percent rate he would have to pay $45,000 tax on this intangible cost, which clearly constitutes a tax on an expense of doing business.

As we understand it, a minimum tax is generally imposed only on "artificial" losses which are deductions from income but have not required a direct cash outlay. Taxation of legitimately paid expenses, however, is contrary to this objective. Such taxation does not further the purpose of a minimum tax—which is to ensure that those who escape taxes because of "artificial" deductions will nevertheless pay a substitute minimum tax. There is no justification for taxing corporate IDCs without regard to their connection with oil and gas exploration. Where individuals are concerned, the focus of the minimum tax is at least limited to IDC deductions which are not linked with oil and gas income. Independents operating as corporations deserve equal treatment.

We recognize that, if Congress determines that increased tax revenue is necessary to help the country's serious economic ills, the energy sector of the economy will undoubtedly join others in paying the bill. If the taxing solution is broad-based, such as a surtax on income tax or a national sales levy in some form, we will not appear in search of exemptions. It is another thing, however, to seek energy's tax help in the form of chipping away at existing tax code incentives which encourage domestic drilling.

Our industry already bears a heavy tax burden. The misnamed "windfall profit" tax reduces the income of domestic producers far below that of foreign suppliers. We feel that the ideal way to eliminate this disparity would be to do away with the "windfall profit" tax altogether. This action would undoubtedly help the nation's economy. It is unfortunate that the Treasury has come to depend on this tax as a major source of revenue.

A few moments ago, I referred to the threat of an international collapse in crude prices. This, combined with the nation's need for revenue to cope with budgetary deficits, suggests that the time may have come to initiate a substantial tariff on imported oil and products. In one stroke, such a move would serve the nation's security by encouraging maximization of domestic energy, raising considerable federal revenue, and encouraging continued conservation of energy by American consumers.

Members of this Committee are probably aware that windfall tax revenue declines some $1.4 billion for every $1.00 drop in the domestic crude price. This could be a substantial loss to the government should crude prices continue to edge toward the $25 per barrel range.

Should an imports fee be pegged at an average crude price of $35 per barrel, the fee would currently provide some $9.1 billion annually. In addition, it would tend to preserve some $7.0 billion in "windfall" tax revenue from domestic supplies. This estimate assumes that the current average crude price at the domestic refinery level is in the vicinity of $30 per barrel and that crude and products imports will average 5 million barrels per day. For every additional $1 decline in the international crude price, an additional $3.2 billion would accrue to the federal government.

This approach would not result in prices to the American consumer higher than what he experienced as recently as December 1981. Furthermore, it would provide "energy" revenue for the nation's needs without endangering the vital function of domestic drilling operations. Conservation objectives would be served, and alternate fuel development would not be devastated as will otherwise be the case.

At the same time, this solution would alleviate the Congressional tendency to erode drilling tax incentives, attack current exemptions to the windfall profit tax, and devise new forms of energy taxation. All such attempts have a negative, self-defeating effect. The resulting reduction in domestic energy would simply mean an increased need for foreign supply—either immediately or in the not-too-distant future. This would not be in the best long-range interest of the American consumer.

We appreciate this opportunity to be heard.

Mr. ANTHONY. Mr. Stafford.

STATEMENTS OF JAMES L. STAFFORD, PRESIDENT, NATIONAL ASSOCIATION OF ROYALTY OWNERS; GWYNNE G. GAZZAWAY, ROYALTY OWNER; AND VERA BARRICK, ROYALTY OWNER, ADA, OKLA., ACCOMPANIED BY CARL T. CURTIS, COUNSEL

Mr. STAFFORD. Mr. Chairman, may I thank the committee for the opportunity to appear to present to the committee some of the facts about royalty ownership.

My name is Jim Stafford. I represent nearly 4,000 members of the National Association of Royalty Owners, which is based in Ada, Okla., and over 38,500 members of regional and State mineral and surface owner organizations in 48 States, that have affiliated with my group.

We were formed in opposition to the windfall profits tax nearly 2 years ago, and are now also active in protecting the rights of royalty owners in many other areas.

A majority of royalty owners—and there are a total of over 2.5 million in the Nation—is either retired or nearing retirement.

One survey we did in conjunction with some congressional subcommittees proved over 73 percent were over 63 years of age. Of these, 43 percent were on social security, 27 percent are widows, 12 percent are disabled and nearly 5 percent are in health care facilities.

About 70 percent live in the 24 major producing States. Over one-quarter have migrated into fringe and nonproducing States, mostly such industrial and financial metro areas as Chicago, New York, Atlanta, and coastal New Jersey.

Others are heavily clustered in Los Angeles, San Diego, and St. Louis, where jobs existed following the Depression.

The average royalty check per month, in a survey of 200 Oklahoma banks, was about $200 monthly.

Our most recent survey among 4,000 royalty owners, who are members of our group, also shows that occupationally 47 percent of royalty owners are retired and on fixed incomes; 21 percent still work on farms and ranches. Only 10 percent are in any way connected with the oil industry, usually as an employee of a well or oil field service company; 20 percent responding were over 75 years of age.

This survey, which has the most active tier of royalty owners of the Nation, also proved that 30 percent exist solely on royalty income and social security.

In 63 percent of the cases, other income, usually seasonal crops or part-time labor, bolstered the efforts.

Five percent do not accept social security and exist on royalty income alone.

Blacks in central Oklahoma, east Texas, Mississippi, and northeastern Louisiana, also account for a sizable portion of royalty owners.

Mr. Chairman, in the passage of the windfall profits tax the rate of tax applied to royalty owners was the same rate applied to major oil companies.

The rate of tax for royalty owners and major oil companies for tier 1 oil was 70 percent, and the rate for independent producers' oil was 50 percent.

The rate of tax for royalty owners and major oil companies for tier 2 oil was 60 percent, and the rate for independent producers' oil was 30 percent.

The rate of tax for royalty owners and major oil companies for tier 3 oil was 30 percent.

These were the same rates applied to royalty owners after the bill had been considered by both tax writing committees, the House of Representatives, the Senate, and signed by the President.

It was in later acts of Congress that a royalty owner's credit and the present exemption was passed.

We now hear reports and rumors that the present exemption of 2 barrels per day, which will later be increased to 3 barrels per day for royalty owners, is in danger of being repealed or lessened.

We sincerely hope that such reports and rumors are not true, and we are here to present the case of these royalty owners.

The tax is proving an unnecessary hardship and should be phased out quickly. It was a punitive tax directed at the major oil companies, but the royalty owners are bearing most of the brunt.

The exemptions offered by the Economic Recovery Act of 1981, which will eventually benefit well over 80 percent, is far from perfect in its execution.

The complexities of the tax, and the purchasing company administration of the gathering of that tax, apply a horrendous burden on the royalty owner. He or she is not equipped to deal with the accounting perplexities of that tax. Thus, many don't file.

Further, the 2 barrel exemption in its practical application, has been distorted by the IRS in contempt of the law, which was designed to pass through to royalty owners their income without undue and untimely confiscation.

The royalty owners need the exemption applied so that their withholding is lessened and they do not have to turn their money over to the Government and then apply for a refund.

Royalty owners, because of their age characteristics and the nature of their investments in mineral properties, are the most vulnerable tax targets in our Nation's history.

The tax was written to criminalize holdings of old oil, and the tax was levied to reflect this feeling.

This category, old oil, plus stripper oil, is held by the oldest categories of royalty owners. Thus, what was designed to stimulate exploration for the producer boomeranged to devastate the most economical sensitive tier of royalty ownership.

It is stressed that overriding royalty interests, too, are unique and should be subject to exemptions, along with royalty trusts formed to evenly divide holdings of large families.

Further, it is noted that many American Indians are not exempt from this tax, and that royalty owners have migrated into every section of the Nation.

It is stressed that any future tampering with natural gas should clearly exempt royalty owners, since this mineral commodity has been produced nearly to extinction from the estates of nearly 500,000 of the Nation's over 1 million owners of natural gas at artificially low and devastating prices, ranging from 7 cents to 50 cents per thousand cubic feet.

These contracts are for the life of the field in which they are situated, and not subject to renegotiation.

It should further be stressed that procontrol advocates of natural gas have long stated that old natural gas and old oil is primarily owned by major oil companies. It is noted that this is totally false and without any trace of support.

It should be finally stressed that royalty owners are not involved in oil politics, have very little, if any, day-to-day activities involving oil companies, and, therefore, should not be targeted by any group seeking to exploit this group for tax purposes.

It should be noted that NARO fears also that New Federalism will become institutionalized and lock in the WPT forever.

This transfer of wealth from producing to nonproducing States is judged discriminatory and unhealthy to the Nation, both in terms of environment and social objectives.

Thank you, Mr. Chairman.

Mr. ANTHONY. Thank you, Mr. Stafford.

[The prepared statement follows:]

STATEMENT OF JAMES L. STAFFORD

My name is Jim Stafford. I represent nearly 4,000 member of the National Association of Royalty Owners, which is based in Ada, Oklahoma, and over 38,500 member of regional and state mineral and surface owner organization in 49 states, that have affiliated with my group. We were formed in opposition to the Windfall Profits Tax nearly two years ago, and are active in protecting the rights of royalty owners in many other areas.

Until our group organized, no one was presenting the case of the royalty owners to the Congress. The interests of the royalty owners is different than the interests of the independent producers and the oil companies of all sizes. It is because of this that royalty owners were hit with the highest portion of that excise tax . . . at the very same rate being applied to the large oil companies. Royalty owners have no way to pass along this tax, and its impact, until the recently passed ERTA of 1981, was devastating.

It will never, under the best circumstances, be mildly tolerable for the reasons I'll explain today before this most distinguished group.

First, it should be noted early in my testimony that to much of the nation and to many members of Congress, the wide differences that distinguish a royalty owner from a producer are not clear. To clarify, the royalty owner is usually removed completely from the day to day workings of the oil business, while the producer, although he may have acquired royalty as the end result of some financial deals, does not consider himself a royalty owner, but an oilman. We are the poor relations.

In view of repeated statements in the press, we feel this difference must clearly be made. We no longer wish to be tarred and feathered by the brush that claims the ERTA of 1980 "gave rich oilmen tax breaks." For background, the royalty owner holds rights to a portion of producing oil or gas wells. These rights usually one-eighth of oil produced and sold, are given back by an oil and gas lease to the royalty owner for the right to drill on his land and to extract the sub-surface assets, which are owned by the mineral owner. The royalty owner is a mineral owner until he gets production.

By constitutional right, sub-surface ownership can be severed from surface ownership. In most cases mineral rights are divided scores of times under tracts of land in producing states.

I have an exhibit to prove this point. It was picked to show over a dozen royalty owners under one tract of 60 acres in my home county. The surface of this land, not fit to graze one small goat, is owned by one individual. Years ago, he sold ½ of his mineral interests to pay his property taxes during the Great Depression. His mineral interests were later sold as investments to other people hoping for retirement income.

This particular property is mainly owned by people in their late 70's. It contains three wells. The average daily production from these three wells is less than two and one-half barrels a day. It provides my mother, with about $75.00 a month income. It is taxed at the highest rate possible as stripper oil. Production is shared under this lease by several retired school teachers, a retired oil field worker, few retired small business owners, a young district attorney who recently inherited an interest, and three retired farmers. The wells will be depleted totally in five years. The surface, after several decades of oil operations, can never again grow crops, or provide adequate pasture to justify the yearly taxes.

This is a typical ownership pattern for Oklahoma, Texas, Louisiana, and Kansas, plus the old oil states of Ohio, Kentucky and parts of West Virginia.

The nature of royalty ownership is closely linked to the history of the oil business. In early days, though, royalties of fifty percent of production were common. Eventually, the oil people, pleading high risks and costs, whittled the typical royalty payment down to an eighth of production. In practice, in most of the nation, it was considered a good financial tradition always to sell off one-half of your royalty before the drilling of a well. The factional interests were often bartered for goods and services, much as livestock. thus many small store owners and professional folks, in hard times, took mineral parcels in lieu of cash payment. The risk, at best, was always ten to one against a producing well, even in the most attractive geologic areas. A trip to Las Vegas, had it existed in the oil boom days of the 20's and 30's, when most major fields were discovered, would have been a much better investment. But, in an area where common stocks were "suspect" and bonds considered "alien", oil royalties were considered one of the few places where an investor with a small income, such as a farmer, rancher or small businessman, could put a few spare dollars aside to dream on.

In other instances, if you were buying a farm to work, usually acre by acre, you had to pay also for the mineral rights. In most all cases in oil producing states, these rights cost from 25 percent of the value of the surface alone to upwards of 2000 percent of the value of the land. This is still true, and in many cases, you still cannot buy land without also buying the minerals. So the oil industry's complaint during the tax debates that we did nothing to earn our rights falls on mad and deaf ears. The royalty owner, thus, does not feel he is getting a free ride, or that he should be severely taxed for his diligence. This is especially true since in most states it is necessary to keep taxes paid on the surface to maintain and hold the mineral rights. To most this has been a burden, since they have had to pay taxes on the surface, which they might not have owned, in order to hold and keep their mineral rights. Most royalty owners, gentlemen, have finally gotten the picture. They are fighting mad. And they feel that the following reasons justify their exemptions.

First, the tax is in violation of the Constitution. It also violates concepts of ownership, mineral ownership, that go back to the book of Genesis.

But further, they feel it is a criminalization of ownership of private property, and nationalization of that property in its most hideous form. They therefore feel that they should be left out out of any further budget considerations.

Royalty owners have no say over the price their assets will bring. That is done by the producer. They also have no say over how much production, or what category of production, their property should produce. That is up to the whim of the state and national laws, plus what the producer can do legally to get a fair price. They also feel, as I, that the federal, state and county tax structures are sufficient penalties for any return they may receive on their mineral investment. They further don't believe that their money should be earmarked forever to a fund, such as the The New Federalism—which means it will never be repealed. They also resent enormously that they must pay, perhaps for eternity, for the political sins of the major oil companies, or others.

They don't mind paying for the needs of the needy, but resent paying for the greeds of the greedy. For example, let's examine a few facts about the two barrels exemption which is now under attack. To most it seems that two barrels a day puts you into oil baron class. Let's look at the facts in Kansas, where a farm family of four already pays, in direct and indirect taxes, over 47 percent of income, according to one farm study.

It is no wonder royalty owners got mad in record numbers. Their whole economic future faded when that bill, the WPT, was signed into law. And the same principle, which we believe is clearly unconstitutional, could be awakened and applied to any asset, whether apartment houses, livestock, automobiles, anything, just at the whim of Congress.

And the wholesale irony of it was that, in order to protect these folks, Congress broke production down into tiers. And it was the most marginal, the most vulnerable area of production which was hit hardest—old oil. The corollary we find is old oil and gas belong to older people that have held onto their holdings. They were hit worst.

Further, these people found out later, (to compound their problem), that their incomes would be withheld by the government for 16 months, until they filed for a refund. It was tough to tell the doctor to wait, that the government had your money for a year. And next they found that the government tax writing expert had made it impossible to get back their money without seeking an expensive tax specialist, whose fee usually exceeded their refund.

Who are these people? Why are they bellyaching?

Our statistics on ownership were compiled in two surveys. One was done in 1980, the other completed last week. These prove what we long suspected—that there is no more pathetic and defenseless group in the nation to single out for such a complex and consuming tax.

A majority of royalty owners—and there are a total of over 2.5 million in the nation—is either retired or nearing retirement. Over 73 percent surveyed are over 63 years of age. Of these, 43 percent are on social security, 27 percent are widows, 12 percent are disabled and nearly 5 percent are in health care facilities. About 70 percent live in the 24 major producing states. Over one-quarter have migrated into fringe and non-producing states, mostly such industrial and financial metro areas as Chicago, New York, Atlanta, and Coastal New Jersey. Others are heavily clustered in Los Angeles, San Diego and St. Louis, where jobs existed following the Depression.

On a state basis, Oklahoma has 250,000 owners of oil royalties, Texas 800,000, Kansas 143,000, Illinois 180,000, California 500,000, New York 200,00 and Ohio 80,000. A list of each state is in Exhibit (B). Each year this number grows, as additional exploration occurs, and as deaths subdivide royalty interests among heirs. (Of these people, of 31,000 surveyed for U.S. Senator David Boren, only 300 had royalty incomes exceeding the pay of a U.S. Senator).

Oklahoma State University estimates that 13 million people could become royalty owners in the next two decades as interests are divided, exploration expands into New England and the Northwest Quadrant, and land units are further divided.

The average royalty check per month, in a survey of 200 Oklahoma banks, was about $200 monthly. NARO estimates that well over 80 percent or more of the nation's royalty owners will be fully exempt from the current tax by 1985, when the three barrel exemption is triggered, but the twenty percent of royalty owners who are not fully exempt are entitled to a lesser burden and the eventual termination of the WPT.

Our most recent survey among 4,000 royalty owners also shows that occupationally, 47 percent of royalty owners are retired and on fixed incomes. Twenty-one percent still work on farms and ranches. Only ten percent are in any way connected with the oil industry, usually as an employee of a well or oil field service company. Twenty percent responding were over 75 years of age. Our survey, which was the most active tier of royalty owners, our members, also proved that 30 percent exist solely on royalty income and social security. In 63 percent of the cases, other income, usually seasonal crops or part-time labor, bolstered the efforts. Five percent do not accept social securty and exist on royalty income alone.

Blacks in central Oklahoma, East Texas, Mississippi, and Northeastern Louisiana, also account for a sizeable portion of royalty owners. Indians unexempt by law also have been victimized by a quirk in the tax. Income from royalty, in thousands of case histories reviewed by my office and by the U.S. Senate Hearings two summers ago, proved that royalty income helped a majority of families maintain their farms and ranches when disasters of economic and nature hit hardest—most notably the Depression years and the recent seven years.

The economic and social impact on these people following the passage of the tax was devastating. Public hearings in the nation filled to overflowing. Congressional offices and media were filled with angry letters. Most had little warning that little oil, the royalty owner, instead of big oil, was about to be lead to the financial slaughterhouse by an ill-named tax.

Our office has thousands of letters, including about 1,000 from Illinois, which is seldom thought of as a producing state. Let's examine its impact there. Let's consider for a moment that land, in the heart of the boom 1938, was selling for $10 an acre. The same land today is $2,000 an acre. In 1938 oil sold for $2.10 a barrel. Using the same financial evaluation, today's oil should sell for $42. It may sell for $25, and at that price the farmer can't afford to lease valuable land and take it from productin to pay the government most of the income and be left with surface damage that may forever ruin his property.

The impact of this tax can also be illustrated by my home county, Pontotoc. The tax cost this county of 36,000 people about $5 million yearly in lost royalty income. With a multiplier of five, which is the barometer the economists use, this was equivalent to losing a factory employing 350 people in this country, according to the City Manager.

Bankers in three states were understandably in a panic after the tax hit. Royalty owners had traditionally pledged their royalty for seasonal crop needs. Churches throughout the nation were hard hit as their collections bottomed out. Sales of farm implements dropped, and sales of farms and ranches increased.

But nowhere was it more hurtful than to the retired, and to the widowed. To most it was terror. They had fought hard to survive a Dust Bowl. At that time some of their brothers and sisters in the industrial states were bargaining for paid vacations and Saturdays off.

They feel lucky to be alive, and luckier to still have their farms. And after the tax, they were just plain confused that the government they respect and love should single out one group, simply because the nation is irked at anyone and anything connected with oil.

Today, because of what they call force pooling in 36 states, a royalty owner cannot withhold his land from lease, even if he should so choose.

That's why the royalty owner is a dying breed. Dick and I, both under 50 years of age, are a rarity. Today, if a mineral owner is affluent, and being pooled, he will readily elect under state law to become a working interest owner, because of the tax benefits, plus the increased payout provided.

Suppose that you are a lawyer just approaching 64 years of age. Over the years you worked hard. Built up a fine little practice. Let's say as a young man you started putting something aside, some investments, to provide for your retirement and to leave a little something for your children. One day in March of 1980, there's a knock on your door. The internal revenue service man tells you they have just confiscated your assets. Congress, unbeknown to you, just decided lawyers had it too easy for 40 years, and had to help bail the nation out of its financial bind.

They said your property had been seized until it could be evaluated and taxed. Later they said your farm, which was an old farm, was to be taxed 70 percent of its value. Your stocks and bonds, which were considered marginal, would be let off with only a 60 percent tax. Your rental property, which you bought after 1977, was classed to be taxed at only 30 percent, and the income would be withheld for a year and then you would be required to file to get back any surplus withheld. They told you as they were leaving that your college roommate, now also a lawyer but in Philadelphia, was to be taxed at a lower rate, because he took the risks of living in a big city.

Absurd, not at all. This is exactly what happened to royalty owners. Our mineral property was devalued instantly the moment the tax became law. Further, the threat of a tax, plus a rollback in payments on stripper oil, decreased buying power and our borrowing power—a vital item in outlasting today's economy. At the same time, the independent producers, because they take risks in a more focused manner, were hit hard, but still can accommodate most of the tax. The majors, the prime target with their profits from imports, went unscathed.

Examine for a moment the impact of the current exemption on two barrels of oil. Two barrels of oil will bring you, at today's prices, $21,000 a year. Without the exemption, this oil would be taxed $8,500, at the rates for old oil. This would leave you only $12,500—the starting salary for a clerk typist at the Department of Energy. From this, the average senior citizen would pay $5,000 for shelter, $3,500 for food, $1,500 for transportation, and $1,000 for medicine and health care essentials. This would leave over $1,500, or $4.10 daily, for such luxuries as insurance, home repair, church and charities, and to cover any non-routine medical emergencies. This does not cover a severance tax at state level.

The 3 bbl exemption, which will come into effect in 1985, is also lusted after by the budget people. These oil barons it would protect would have incomes of $32,850. After federal, state and local taxes, and an average severance tax, they would have the non-taxed income equal to the starting salary of a college graduate in 1982 from Northwestern University with a MBA degree.

With these factors in mind, we respectfully urge this committee not only to keep the current exemptions in place, but to consider phasing out royalty owners completely from under this mistake in taxation as soon as possible.

Reasons summarized include: (1) the tax is directly inverted as it applies to the needs of the royalty owner (old oil taxed highest), and it deprives him of needed income; (2) it creates an accounting problem that has 20 percent of royalty owners unable to file, this year, for the credits because of complexities; (3) the current federal income taxes and state severance taxes already tax this depleting asset to the fullest limit; (4) the royalty owner is unable to pass along the tax or to maneuver in such a manner as to avoid the tax; (5) the tax confiscates and devalues his investment without just compensation.

We further believe that all royalty owners should be exempt. Those in the higher brackets have risked capital in direct proportion to their return, and without notice or warning this tax captured their assets. This has placed hardships on every royalty owner in the nation, and not just a few.

We feel further that the beneficiaries of royalty trusts should also be made eligible for the exemption. They currently get no relief. The same should be true of overriding royalty interest holders, who may have accepted an override rather than what is known as an excess royalty simply because it was printed in the lease.

We must point out that the independent producers are not tied to one property. If they are unsuccessful with a well, they can pull up stakes and try again. Mineral owners do not have this advantage. Most are locked into one, two or at the most, three tracts or parcels of land. At the 50 to 1 rate of successful completions, they are high risks in this venture.

Royalty owners must live with drilling mistakes. This means if a producer fouls up a hole, the property is worthless. He can't pick up and start over by heading to the bank or to a group of shelter-seeking investors to finance a well.

We further feel that decontrol of natural gas is the only salvation of over 500,000 of 1 million holders of natural gas properties. These people are locked into non-negotiable contracts at a small fraction of current market value.

Without decontrol, these assets will be depleted forever at such rates as $.07 per thousand cubic feet. We feel stringent efforts must also be made because of the variances in natural gas pricing, which is not a free market, to protect forever the royalty owner of this commodity from any future taxation mistake which would lump him into the category of a producer.

We also feel that our financial health is closely linked to the producer, and urge that he be set free so the nation can gain energy independence without the federal tampering which has proved unsuccessful time after time in the United States.

We believe any shortfall from exempting royalty owners can more than adequately be made up in taxing imports, preventing oil thefts from federal lands—which we believe to be much greater than reported—and from thefts to avoid the WPT in industry. Further, we believe the royalty owner, because of the wide range of his financial spectrum, is the best judge of where to spend his money, and that the current tax system more than adequately penalizes him for taking the risks and earning the capital necessary to taking those risks in hopes of attaining a profit and a retirement income.

BIGHEART PIPE LINE CORPORATION

Exhibit A

DIVISION ORDER
#9074

May 18, 1965
(Date)

BIGHEART PIPE LINE CORPORATION, Petroleum Club Building, Tulsa, Oklahoma

Each of the signers hereof guarantees and warrants that the interest set opposite his name below is his correct ownership in the oil (which, for the purposes hereof, includes all liquid hydrocarbons purchased hereunder) produced from the Eason Oil Co. - Duncan lease described as

S/2 NW SW Sec. 26-5N-4E,

A twenty-acre tract with one producing stripper well

If the well were producing 2 bbls. per day, multiply the gross proceeds per day times the individual division of interest to determine the royalty owner's share. Then deduct state severance and ad valorem taxes and windfall profit tax. What is left is taxed as personal income.

located in Pontotoc County, State of Oklahoma, and commencing March 1, 1965 at 7:00 a.m. and until further written notice either from you or from us, you are authorized to receive oil therefrom, purchase it and pay therefor as follows:

OWNERS' SOCIAL SECURITY OR TAX ACCOUNT NO	CREDIT TO	DIVISION OF INTEREST	ADDRESS
	Lucille Chism Bates	.0034722 RI	1st Savings Bldg., San Angelo, Texas
	Ether Chism	.0069445 RI	%K.C.Bates, 1st Savings Bldg., San Angelo, Texas
	S. K. Duncan	.0208334 RI	705 N.Okla. St., Shawnee, Okla.
	Eason Oil Co.	.6875000 WI	Box 9755, Okla.City 18, Okla.
	Flora Mae Gullatt	.0052083 RI	Box 130, Ada, Okla.
	Frances Rives Gwin	.0069444 RI	105 E.Main, Ada, Okla.
	Wilma Chism Lain	.0034722 RI	Box 331, Ada, Okla.
	Norma Chism McCarthy	.0034722 RI	Box 985, Seminole, Okla.
	Mary Louise Nommensen	.0034722 RI	11615 Starwood Dr., Houston 24, Texas
	William G. Peterson	.0052083 RI	%Okla.State Bk., for Deposit only, Ada, Okla.
	Frances Rives Gwin & Ed Gwin Jr., Co-Trustees, U/W of Stella M.Rives, Decd.	.0138889 RI	105 E.Main, Ada, Okla.
	B. Rixleben	.1458334 WI	Box 60, Ada, Okla.
		(See Attached Rider)	

(Continued on Reverse Side)

The covenants appearing on the reverse side hereof are a part of this division order and shall be binding upon each of the signers hereof, their respective successors, legal representatives and assigns.

WITNESSES SIGN BELOW

OWNERS SIGN BELOW

Exhibit B

ROYALTY OWNERS - STATE BY STATE

Arkansas	50,000	
California	300,000	
Colorado	20,000 +	
Florida	15,000	
Illinois	180,000	
Kansas	188,000	
Louisiana	104,000	
Michigan	19,000	
Mississippi	10,000	
Missouri	5,000	
Montana	15,000	
Nebraska	6,000	
New Mexico	60,000	
New York	40,000	(approx. 5,000 producing stripper wells)
North Dakota	10,000	
Ohio	80,000	
Oklahoma	200,000	
Pennsylvania	108,000	
Texas	650,000	
Utah	5,000	
West Virginia	56,000	
Wyoming	40,000	
Kentucky	55,000	

These figures are based on the number of producing wells in each state, with a multiplier of 4 for each well. This conservative figure is based on first and second generation ownership, and does not take into account migration of second and third generation ownership, and the sale of severed mineral interests.

Mr. ANTHONY. Ms. Gazzaway.

Ms. GAZZAWAY. Thank you.

My name is Gwynne Gazzaway. I am a widow 55 years old. I am a mother and a grandmother. I am also an oil royalty owner. The majority of my royalties are in Texas and Oklahoma.

In the summer of 1979 the future of the windfall profits tax was very much an issue in America, and I became very concerned.

Therefore, I contacted friends in the circumstances similar to my own, middle income, widowed, and completely dependent on their royalty income.

Each of us contacted other royalty owners—royalty owners in both producing and nonproducing States. We did this by using the names and addresses given on our division orders.

We decided to take action protesting the windfall profits tax for we all felt that it invaded our constitutional rights. At the time, the teachers were striking, the truckers were striking; therefore, we decided not to sign leases. We felt this was the only way to bring our plight to public attention. The press picked up our story and dubbed us "Widows on the Warpath."

For months my phone rang from 7 in the morning until 11 at night. I found royalty owners that were librarians, teachers, farmers, taxi drivers; I even found a policeman. You have businessmen. We are from every walk of life. You just can't target us and place us in one group.

The really tragic part was the elderly. At the time three-fourths of the people I talked to were in their seventies, living on a small social security check and an equally small royalty check.

One woman, whose brother was a producer, was left a few royalties by her brother and found herself with a total income of $350 a month. this included both her royalty and her social security check combined.

She injured her leg and the lady called me and said she was afraid to go to the doctor for fear she could not pay her rent if she did.

Another royalty owner was a taxi driver with an income of $150 a month were it not for the windfall profits tax.

I am sure you know the windfall profit tax takes approximately 40 cents from every royalty dollar. The man is the father of six children, drives a cab 12 hours a day and I surely believe he does need that check, his full check, that is.

The royalty owner that I am never going to forget was a 90-year-old black woman from east Texas. She is now deceased. She had no social security. Her small royalties were her only income.

When we finally reached the $1,000 tax refund, this woman could no more understand how to do it than she could afford to hire an accountant. I think approximately half of the small royalty owners could not afford to hire accountants.

This being the case, many of them never file for their thousand dollar refund. That is why we look forward to the two-barrel exemption. And truly it has been our first ray of hope.

As I understand it, it will eliminate a lot of redtape from small royalty owners in this case, and the necessity for accountants will be eliminated for the small royalty owners.

I am a member of the National Association of Royalty Owners. I am very grateful for it. It has helped us a lot. I was forced to give up my own organization due to ill health.

In the past 2 years I have had two major cancer surgeries which have left me pretty well strapped.

In 1980, before the windfall profits tax was taken from my income, I would have had approximately $25,000 as my yearly income from royalties. And that is my total income. After the windfall profits tax took $6,000, I was left with $19,000. That year I had approximately $17,000 in medical expenses. I have a $60-a-day hospitalization policy, and that is my only medical insurance.

Two weeks ago during my last hospitalizatin I found that a postage stamp size of a room cost me $182 a day. I tried to get one for less, but we have had a good deal of flu down there recently. I think they started about $140.

As my cancer checkups will have to continue approximately every 2 months, my medical expenses will continue. Unfortunately, doctors do not wait for Government refunds. Neither do your other creditors.

I am really looking forward to that two-barrel exemption. The elderly, again, though, they are really the ones who suffer. They are in nursing homes. And those—those who can afford it are. Many of them can't, and they are just barely making it.

I cannot believe that you all, you Congressmen, would have done this had you realized this was the case. I watched you, and I think you try awful hard.

Anyway, excuse me.

Now in this country, a surface owner, they can get anything they want for their property, just about. They do not have to pay an excise tax. However, the royalty owner has had it socked to him.

I would like to know one thing. Why us? Why tax the oil royalty owner? You don't tax the coal royalty owner nor the timber royalty owner.

Basketball players make tremendous amounts, actors make tremendous amounts. If you will think, someone like Johnny Carson, I hope this is permissible to say, you don't put a windfall tax on him.

But, because we have the name "oil" before us, we get targeted, discriminated against.

But, anyway, to get back to it, I believe that I am a fairly good American. I gave up my husband. He was killed flying troops to Vietnam. My son was seriously wounded fighting in Vietnam. And I care very much for this country, and I don't mind paying a just income tax.

However, I do mind paying a double tax. I mind for myself, and I mind for the nearly 3 million other royalty owners. For double taxation is exactly what windfall profits tax is. We not only pay the Government twice, we have ad valorem taxes taken from us before we pay a check, no, we pay those, then receive a severance tax before we get a check.

Federal taxes, State taxes, we are taxed to death. I receive my royalties on minerals through my father. He was a small independent producer. He worked very hard to leave me something, and I am very grateful for it, for I really don't know what I would do without him right now.

I am quite sure there really isn't one parent in this room that wouldn't like to leave his or her children something, no matter how small it is or how large it is.

I do thank you very much, gentlemen, for hearing me. It isn't in the written testimony and I would like to say excuse me if I get a bit emotional on this, but to me it is quite important.

Thank you.

Mr. ANTHONY. Thank you for your testimony, Ms. Gazzaway.

[The prepared statement follows:]

STATEMENT OF GWYNNE GREER GAZZAWAY

My name is Gwynne Gazzaway, I am a widow fifty-five years old. I am a mother and a grandmother. I am also an oil royalty owner. The majority of my royalties are in Texas and Oklahoma.

In the summer of 1979 the future of the Windfall Profits Tax was very much an issue in America. I became very concerned. Therefore, I contacted friends in the circumstances similar to my own, middle income, widowed, and completely dependent on their royalty income. Each of us contacted other royalty owners—royalty owners in both producing and non-producing states. We did this by using the names and addresses given on our division orders.

We decided to take action protesting the Windfall Profits Tax for we all felt that it invaded our constitutional rights. At the time, the teachers were striking, the truckers were striking; therefore, we decided to refuse to sign leases. We felt this was the only way to bring our plight to public attention. The press picked up our story and dubbed us "WIDOWS ON THE WARPATH".

For months my phone rang from seven in the morning until eleven at night. I found royalty owners that were librarians, teachers, farmers, taxi drivers; I even found a policeman.

The really tragic part was the elderly. Three-fourths of the people were in their seventies, living on a small social security check and an equally small royalty check. One woman, whose brother was a producer, was left a few royalties by her brother and found herself with a total income of $350.00 a month. This included both her royalty and social security check combined. She injured her leg badly and was afraid to go to the doctor for fear she could not pay her rent and a doctor also. This lady ended up in a church charity nursing home. Another royalty owner, a taxi driver, would get approximately $150.00 monthly were it not for the Windfall Profits Tax. However, the Windfall Profits Tax takes approximately 40¢ from every royalty dollar. The man is the father of six children, drives a cab twelve hours a day, and I am quite certain, he could use his full check.

The royalty owner I will never forget was a ninety-year old black woman from East Texas. She is now deceased. She had no social security. Her small royalties were her only income. When we finally reached the $1,000 tax refund, this woman could no more understand how to do it than she could afford to hire an accountant. Approximately half of the small royalty owners could not afford to hire accountants. This being the case, too many of them never even filed for their $1,000 refund.

This is why the two-barrel exemption is our first ray of hope. As I understand it, much red tape will be eliminated and the necessity for hiring accountants eliminated in the cases of the small royalty owners.

Presently, I am in the National Association of Royalty Owners. I was forced to give up my own organization due to ill health. The past two years I have had two major cancer surgeries which have left me pretty well strapped. In 1980, before the Windfall Profits Tax was taken from my income, my yearly income would have been approimately $25,000. After the Windfall Profits Tax took $6,000, I was left with $19,000. That year I had approximately $17,000 medical expenses. With $60 a day as hospitalization as my only medical insurance, my economic situation was rough. Two weeks ago during my last hospitalization, I found a postage-stamp size of a room cost me $182.00 a day. As my cancer check ups have to take place every two months, my medical expenses will continue. Unfortunately, doctors do not wait for government refunds. I, therefore, have looked forward to our two-barrel exemption.

The elderly, however, have really suffered this tax. They are in nursing homes, those that can afford it. Many that cannot, are just making it. Surely, Congress did not realize this. In this country a surface owner can get about anything he or she wants for their property. They do not have to pay an excise tax. The mineral owner, on the other hand, has had it socked to him. Why us? If you are going to tax royalty owners in this manner, why not the coal royalty owners? Or the timber royalty owners? Why target one group of individuals merely because of the name OIL?

I feel that I am a fairly good American. I have given up a husband. He was killed flying troops to Viet Nam. My son was seriously wounded while fighting in Viet Nam.

I care for my country and I do not mind paying a just income tax. I do mind, however, for myself and for nearly 3,000,000 other American royalty owners, double taxation and that is exactly what the Windfall Profits tax is. I will add one more thing. Not only do we pay the government twice, we have ad valorem taxes, severance taxes, production taxes, the graduated Federal income tax; in fact, we are taxed to death.

To explain to you how I obtained my ownership of minerals and royalties, my father was a small, independent producer. He worked hard to be able to leave his child something. I am extremely grateful for it, for right now I am unable to work and do not know what I would do without his income. I am quite sure there is not one parent in this room that would not try to leave his or her child something no matter how large or how small.

Thank you very much for hearing me, gentlemen. I appreciate your attention and hope now that I have given you the facts, you will better understand our situation.

Mr. ANTHONY. Ms. Barrick.

Ms. BARRICK. My name is Vera Barrick, and I am a royalty owner from Ada, Okla.

I was born in Pontotoc County, Okla., and I have lived there all my life. I will be 68 years old next month, and I have been a widow since 1976. I have two children and five grandchildren.

I first heard about the windfall tax from the man who has our lease. He called and asked me if I knew they were going to start taxing our oil, and would be taking 40 or 50 percent of what we were getting. I told him nobody had told me about it, and he said the Government hadn't told anybody about it. They just did it.

I just couldn't understand why they would want to tax my oil when I was getting such a little bit. I didn't think it was right, and I didn't think it was fair, and nobody asked the royalty owners how they felt about it beforehand.

When my husband, Bill, died in 1972, he left me a part of the minerals on his farm. I get a check for about $150 or less every month. Sometimes it is almost $200, but this last month it was only $78.42.

When momma died in 1951, daddy divided up the minerals from her parents' farm between me and my seven brothers and sisters. I get a check for about $10 every month for that well, which has been pumping since 1927. Ten dollars might not sound like much, but it helps pay for my medicine and that well won't last much longer.

Last year the oil companies sent me the forms to fill out to get my refund for the windfall tax. I looked at them and knew I couldn't do it, because my income is so small, I don't even have to file an income tax return.

I asked my son Frank if he knew how to do it, and he said I had better get some help from somebody who knew what was going on.

I called the royalty owners office, and they told me that the IRS had a man at the post office once a week to help people fill out their papers.

But I can't climb the stairs at the post office, and couldn't stand in line a long time to wait my turn. So the people at NARO said they would help me. And they helped me this year, too.

Now that we have the two-barrel exemption, I won't have to wait for my money, and that is a big relief, because I need every penny just to get by and pay my bills. And it is a lot easier to just sign that certificate than to have to fill out the forms and then wait for a refund.

When I get to thinking about how I would get along without my royalty checks I get frightened. I rent my little house, and if they go up on the rent. I would be in a bad way.

By the time I pay for my groceries, my medicine and my insurance, there isn't much left. I make all my own clothes because I can't afford to buy them ready-made, and I don't spend money for any recreation at all.

I have an old 1965 model car that gets me to church and the store, and back, and right around there in the town where we live, and that is about all it is good for.

I get my social security every month, and I have to make that go as far as it can, because I never know how much my royalty check will be from 1 month to the next, and never know when it will give out. Those are old wells, and they won't last forever.

This is not a very nice expression, but I will repeat it. I have never been in Washington, D.C. before, but I think it is a beautiful place. That isn't really what I had in mind to say but, anyway, it is a beautiful place up here. In fact, I have never been in a big city. But here is what I did want to express.

My son Frank said, "Momma, you have got more guts than a Government mule, so just go up there and tell them what you think about the windfall tax."

There are lots of people just like me. I have worked hard all my life, raised my family, and tried to live right. People say that they understand how hard it is to get by when all you have is social security and a little bit of extra money coming, but unless they have tried it, they just can't know what it is like.

I want to be on my own. I don't wnat to have to live with my kids, and I sure don't want to have to go to a nursing home. I just want to be able to take care of myself with a little bit of dignity, and I can't understand how my Government thinks they have a right to the little bit I have got. And I can't figure why I should be penalized because some big companies are making a lot of money off of oil.

That windfall tax I paid last year was only about $60 a month, and to some of you that is not much money at all. But for me, it means I can pay my bills and not worry so much.

And if I should get sick or have some kind of emergency, it would make a big difference.

I can't go back to work. I have had a cataract operation and three other operations. My back was hurt a few years ago, and I can't walk long distances, or stand or sit in one place for very long at a time.

I take medicine for high blood pressure, and have to be careful about what I do. Besides, for people my age in Pontotoc County, there is no place to work.

This windfall tax is very unfair. It hurts a lot of people. I know that my friends who are retired must all have a hard time. The two-barrel exemption helps the ones who need their royalty checks to make ends meet, and when I heard that some people up here wanted to get rid of it, I decided I had better do something to help save it.

Sometimes, when people in Congress make laws, they just look at numbers, an they forget that the laws affect people. People like me, and my children and my grandchildren.

When I am gone, I would like to be able to leave a little something for my family, just like Bill and momma did. It won't be much, but it might help out if times get too hard. And I would like to be able to get by without charity, and without being a burden to anyone for as long as I live.

That has always been a fear of my life, because I have worked in a hospital and know what it is all about to be in a condition where you have to be that way.

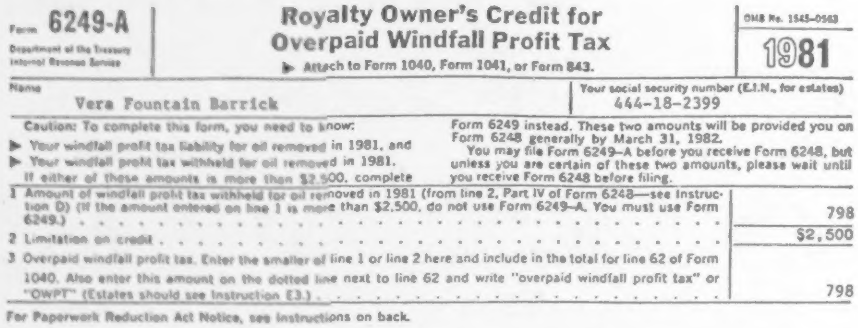
If you people don't think I need that $60 a month, or think that I don't have a right to what was left to me by my husband and my mother, I guess you will decide to take it back.

But if you vote to take away our exemptions, I hope you will remember Vera Barrick, who sat here and told you the straight truth. But there is not words in my vocabulary to tell you what it is like these days to get by on a very small income.

Ask yourself if it is really fair to take that money away.

Thank you.

[Attachments to the prepared statement follow:]



Form **6249-A**
Department of the Treasury
Internal Revenue Service

Royalty Owner's Credit for Overpaid Windfall Profit Tax

▶ Attach to Form 1040, Form 1041, or Form 843.

OMB No. 1545-0563

1981

Name
Vera Fountain Barrick

Your social security number (E.I.N., for estates)
444-18-2399

Caution: To complete this form, you need to know:

- ▶ Your windfall profit tax liability for oil removed in 1981, and
- ▶ Your windfall profit tax withheld for oil removed in 1981.

If either of these amounts is more than $2,500, complete Form 6249 instead. These two amounts will be provided you on Form 6248 generally by March 31, 1982.

You may file Form 6249–A before you receive Form 6248, but unless you are certain of these two amounts, please wait until you receive Form 6248 before filing.

1 Amount of windfall profit tax withheld for oil removed in 1981 (from line 2, Part IV of Form 6248—see Instruction D) (If the amount entered on line 1 is more than $2,500, do not use Form 6249–A. You must use Form 6249.)	798
2 Limitation on credit	$2,500
3 Overpaid windfall profit tax. Enter the smaller of line 1 or line 2 here and include in the total for line 62 of Form 1040. Also enter this amount on the dotted line next to line 62 and write "overpaid windfall profit tax" or "OWPT" (Estates should see Instruction E3.)	798

For Paperwork Reduction Act Notice, see instructions on back.

Form 843
(Rev. June 1976)
Department of the Treasury
Internal Revenue Service

Claim

If your claim is for an overpayment of income taxes, do NOT use this form (see Instructions)

Please print or type

Name of taxpayer or purchaser of stamps: Vera Fountain Barrick

Number and street: 611 South Cherry

City or town, State, and ZIP code: Ada, Oklahoma 74820

Fill in applicable items—Use attachments if necessary

1 Your social security number: 444-18-2399

2 Employer identification number:

3 Internal Revenue Service office where return (if any) was filed:

4 Name and address shown on return, if different from above:

5 Period—prepare separate form for each taxable period
From January 1, 1981, to December 31, 1981

6 Amount to be refunded or abated: $ 798.00

7 Dates of payment: Witheld from royalty checks by Bigheart Pipeline Corp. & Western Crude Oil

8 Type of tax
☐ Employment ☐ Estate ☐ Excise ☐ Gift ☐ Stamp X Windfall Profits Tax

9 Kind of return filed
☐ 706 ☐ 709 ☐ 720 ☐ 940 ☐ 941 ☐ 990-PF ☐ 4720 ☒ Other (specify) ▶ NONE

10 Explain why you believe this claim should be allowed and show computation of tax refund or abatement.

I did not have enough income to be required to file an income tax return. I have completed and attached Form 6249-A indicating the amount of windfall profits tax witheld in 1981.

Under penalties of perjury, I declare that I have examined this claim, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

Signed Vera Fountain Barrick Dated 3-23 1982

Director's Stamp
(Date received)

For Internal Revenue Service Use Only
☐ Refund of taxes illegally, erroneously, or excessively collected.
☐ Refund of amount paid for stamps unused, or used in error or excess.
☐ Abatement of tax assessed (not applicable to estate or gift taxes).

See Instructions on back.

Form **6248**
Department of the Treasury
Internal Revenue Service

ANNUAL INFORMATION RETURN OF WINDFALL PROFIT TAX -- 1981

OMB NO. 1545-0224
Copy D--
File With Producer
or Other Recipient

Producer or Other Recipient		Filer
Name,address,and Zip code VERA BARRICK 611 SOUTH CHERRY ADA OK 74820		Name,address,and Zip code Western Crude Oil, Inc. 060161 P. O. Box 5568 Denver, CO 80217
Employer identification number	Social Security number if any 444-18-2399	Employer identification number 84-0594230

If the information on this return is based on a Form 6248 received from another person, provide the name and employer identification number of the person who furnished you Form 6248

Name	Employer identification number

Part I Producer Or Other Recipient

Type of Producer (Check all applicable boxes) ☒ Individual ☐ Partnership ☐ Corporation ☐ Estate ☐ Trust ☒ U.S. citizen or entity or resident alien
☐ Resident of U.S. Possessions ☐ Foreign citizen or entity, or non-resident alien

Producer Status (check all applicable boxes) ☐ Independent producer ☐ Integrated oil company ☐ Member of "related group" ☐ Operator ☐ Producer with no withholding ☒ Royalty owner ☐ Working Interest

Part II Exempt Oil

Number of barrels of exempt oil	Tier one (a)	Tier Two (b)	Tier three: Newly discovered (c)	Tier three: Incremental tertiary (d)	Tier three: Heavy (e)
(1) Qualified governmental interests. . . .					
(2) Qualified charitable interests.					
(3) Exempt Indian oil					
(4) Exempt Alaskan oil					
(5) Exempt front-end oil					
(6) Total exempt oil (add amounts on lines 1 through 5, columns (a) through (e))					

Part III Information on Taxable Oil Removed During 1981

	Number of barrels of oil (a)	Aggregate removal value (b)	Aggregate adjusted base value (c)	Aggregate state severance tax adjustment (d)	Tax liability (e)
1 Tier one, other than Sadlerochit oil:					
A Subject to 70% tax rate					
B Subject to 50% tax rate					
2 Tier one, Sadlerochit oil:					
A Subject to 70% tax rate					
B Subject to 50% tax rate					
3 Tier two oil taxed at 60%	63	2246	874	97	765
4 Tier two oil taxed at 30%					
5 Tier three, newly discovered oil . . .					
6 Tier three, incremental tertiary oil . .					
7 Tier three, heavy oil					
8 Total (add lines 1 through 7)	63				765

Part IV Windfall Profit Tax Liability for Oil Removed During 1981

1 Amount of windfall tax liability for oil removed during 1981 (from Part III, line 8, column (e)) . . .	765
2 Amount of windfall profit tax withheld with respect to oil removed during 1981	765
3 If line 1 is greater than line 2, subtract line 2 from line 1. This is amount of underwithheld windfall profit tax	
4 If line 2 is greater than line 1, subtract line 1 from line 2. This is the amount of overwithheld windfall profit tax	

Part V Amount of Windfall Profit Tax Withheld from Payments Made in 1981

Amount of windfall profit tax withheld from payments made in 1981 (regardless of when liability for windfall profit tax arose)	778

Windfall profit tax withheld from payments made in 1981 (regardless of when windfall profit tax liability arose) .

OWNER NO. 012907
VER[illegible]NTAIN BARRICK
[illegible]ERRY
ADA OK 74820

BIGHEART PIPE LINE CORPORATION
[illegible] TULSA, OK 74101
(918) 582-7211

Form **6248**
Department of the Treasury
Internal Revenue Service

Annual Information Return of Windfall Profit Tax—1981

OMB No. 1545-0224

Copy D—File with the Producer or Other Recipient

Producer or Other Recipient
Name, address, and ZIP code 444-18-2299

Employer identification number
Social security number, if any

Filer
Name, address, and ZIP code 73-0628156

Employer identification number

If the information on this return is based on a Form 6248 received from another person, provide the name and employer identification number of the person who furnished you Form 6248:

Name
Employer identification number X

Part I Producer Or Other Recipient

Type of Producer (Check all applicable boxes) ☐ Individual ☐ Partnership ☐ Corporation ☐ Estate ☐ Trust ☐ U.S. citizen or entity, or resident alien ☐ Resident of U.S. Possessions ☐ Foreign citizen or entity, or non-resident alien

Producer Status (check all applicable boxes) ☑ Independent producer ☐ Integrated oil company ☐ Member of "related group" ☐ Operator ☐ Producer with no withholding ☐ Royalty owner ☐ Working interest

Part II Exempt Oil

Number of barrels of exempt oil	Tier one (a)	Tier two (b)	Tier three: Newly discovered (c)	Tier three: Incremental tertiary (d)	Tier three: Heavy (e)
1 Qualified governmental interests					
2 Qualified charitable interests					
3 Exempt Indian oil					
4 Exempt Alaskan oil					
5 Exempt front-end oil					
6 Total exempt oil (add amounts on lines 1 through 5, columns (a) through (e))					

Part III Information on Taxable Oil Removed During 1981

	Number of barrels of oil (a)	Aggregate removal value (b)	Aggregate adjusted base value (c)	Aggregate state severance tax adjustment (d)	Tax liability (e)
1 Tier one, other than Sadlerochit oil:	4	125	66	4	.33
A Subject to 70% tax rate					
B Subject to 50% tax rate					
2 Tier one, Sadlerochit oil:					
A Subject to 70% tax rate					
B Subject to 50% tax rate					
3 Tier two oil taxed at 60%	4				33
4 Tier two oil taxed at 30%					
5 Tier three, newly discovered oil					
6 Tier three, incremental tertiary oil . . .					33
7 Tier three, heavy oil					33
8 Total (add lines 1 through 7)					

Part IV Windfall Profit Tax Liability for Oil Removed During 1981

1 Amount of windfall profit tax liability for oil removed during 1981 (from Part III, line 8, column (e))	
2 Amount of windfall profit tax withheld with respect to oil removed during 1981	
3 If line 1 is greater than line 2, subtract line 2 from line 1. This is amount of underwithheld windfall profit tax . .	33
4 If line 2 is greater than line 1, subtract line 1 from line 2. This is the amount of overwithheld windfall profit tax .	

[By subsequent unanimous consent, the following were inserted in the record:]

STATEMENT OF RICHARD T. SHORT, VIRGINIA BEACH, VA.

Mr. Chairman, the Constitution of the United States of America stands like a tall tree. Once cut down such a tree is not easily replaced. This Nation became strong through individual initiative. Individual initiative thrives best in the Free Enterprise System. When the Free Enterprise System is threatened, private property is threatened, and when private property is threatened, then freedom is threatened. When you no longer have a free economy, you are no longer free, because you must look to the government for your livelihood, (I now, today, look to you for my livelihood because today you take seventy percent of my income and 85 percent of old oil income.) You control my pocketbook. You control my pocketbook more than any other investment pocketbook in America.

When the government controls your pocketbook, it will in all likelihood control you. Our Founding Fathers understood this truth and therefore protection of private property was written into the Constitution. Private property provides independence from government. A citizen can object to the government as long as his livelihood is not dependent on that government. But when that government can seize the income from property, then it is only a step away from seizing the property itself. Once the United States Congress charts a course of confiscation of oil property income—which it has done—then one wonders whose property will be next—will it be the coal field, or farms, or manufacturing firms or products that have risen in price to a degree that the Congress as a body feels is obscene? Indeed, all property is endangered. No property is safe.

I have been advised that you gentlemen already are fully aware of the above. I prefer to think that President Carter was acting from emotion when he proposed his Windfall Profits Excise Tax. I think the House and the Senate were caught up in that emotion. That emotion has subsided to some degree. With the belief that sense may now prevail, I ask that you give much thought to the unfairness and unsoundness of the WPT on the oil industry that has served this nation well—as has all segments of the Free Enterprise System—and that future legislation will be with equal taxation to all segments of our system instead of discriminatory legislation against one industry and particular discriminatory legislation against a specific part (old oil) of the industry and even more discrimination against the investor (royalty owner) of that industry.

My family has oil interest in Louisiana. Senator Curtis has seen the run sheets on our property. The income today is about one-half of what it was one year ago. I believe the Windfall Profits Excise Tax is so high today that it is counter-productive on many properties within the United States of America and thus even counter-productive for the Internal Revenue Service. I further believe that the Congress has not taken into consideration that oil income is not like income which can be produced year after year, such as farm crops, manufactured articles, the service industries, dividends, rents, interest, etc. For the royalty owner, once his oil is sold it is gone. It can't be produced again. The royalty owner parts with his property.

As an oil investor, I have tried to take a part of the income from oil and re-invest the money in another American venture. Much of my interest has been toward energy saving inventions. Solar investments are one type of investment that I have participated in. Another invention may allow an automobile to operate with 65 octane and accomplish complete combustion. The Library of Congress is now working with a Committee in Congress on this invention. Research is expensive. Investments in research have proved to be most profitable for our nation. Without research, a business dies. With the tax currently imposed on the oil investor, there is not much left for research.

I do not come to you today and ask that you give me a break on taxes that I justly owe and pass my bill on to another segment of the oil industry. However, I do resent being taxed at a higher rate than another part of the oil industry. You now tax the royalty owner at the highest rate of any segment of the oil industry. With the $227 billion dollar price tag placed on decontrol any exemption or change in the tax structure for one person places an even larger tax on the remaining person. The existing tax rate is too high for all persons and corporations in the oil business. This industry has good and bad years like all industries within our nation. When the home builders have a good year you do not impose a Windfall Profits Excise Tax. When the auto industry had a good year you did not impose a Windfall Profits Excise Tax. I have never understood why the Congress blamed the American royalty owners (and the tax certainly seems to have much vindictiveness in it) for the increase in the price of oil.

Oil was decontrolled because it was necessary to do so to increase production, but because of the structure and burden of the Windfall Profits Excise Tax, the government is still controlling the industry to the detriment of our economy.

As a member of the Board of Governors of the National Association of Royalty Owners, as a member of Gulf Oil Corporation's Governmental Advisory Council, and as a former member of the Board of Directors of Louisiana Association of Independent Producers and Royalty Owners, I welcome your questions. I am not a sophisticated oil investor, but I will answer any questions with complete honesty and to the very best of my ability.

FARM JOURNAL, April, 1982

Hear me . . .

A Virginia farmer explains why all landowners should join together to

Get the Windfall Profits Tax changed

By ARCHIE M. SMITH JR.

■ You have a basic right, written in blood during the American Revolution, to be an oil and gas royalty owner. And as the search for new energy expands, you may become one.

Oil was discovered on my family's land in Louisiana 37 years ago. Oil and gas royalties have financed our cattle farm in Virginia, educated three children and enabled us to establish a fine vineyard.

Now we are threatened by a modern version of an old tax abuse. I mean the so-called Windfall Profits Tax (WPT), which taxes our oil at the same rate as the major oil companies. Do you understand how seriously this tax endangers your property rights? Not many farmers and ranchers do. Listen to those who speak from grim experiences:

"My sister worked up to age 72 on the family farm (360 acres carved out of territorial wilderness)," one farmer wrote the National Association of Royalty Owners (NARO). "Now IRS lumps her with Exxon and Texaco and takes 34% of her life-sustaining oil royalty. . . . But she is proud and independent and won't last long on welfare."

Another protest: "My father worked 16 hours a day during the Depression to hold on to his land. . . . My husband worked long hours as a dairyman and contractor. My grandchildren worked to pay for their educations. We now pay income tax and Windfall Profits Tax that takes one third at the well, plus the consumer's tax on gasoline. . . . The Boston Tea Party and Magna Carta resulted from rebellion at taxation. We three generations are angry."

Recent legislation exempting two barrels of oil per day from Windfall Tax improved situations like these. Still, there's a strong new movement in Washington to put a windfall tax on natural gas at the wellhead also.

Let's get to basic principles: The land belongs to that woman whose family carved a farm out of wilderness. Nobody disputed her full ownership of the land's minerals until these became scarce.

Landowner's and oil company oil sold for years under price controls at a fifth or a sixth of the world price. When Congress took the price lid off domestic crude oil on Aug. 17, 1979, landowners receiving royalties hoped to gain. Instead, Congress took most of the price increase back from U.S. landowners by imposing the Windfall Profits Tax.

Sales of assets attached to the land, *your oil*, suddenly became taxable like 100% profit. Why? Because you didn't do anything to *earn* those assets. On the theory that these honest profits are unearned income (for shame!), the WPT takes 30% of the price increase for newly discovered oil. The tax rate is 70% for oil already under production before prices were decontrolled.

I argued recently with a Washington tax lawyer that no established procedure existed for taxing sales of assets naturally attached to land as though the income were all profit. History shows that Congress can tax whatever it wants, he replied, adding that the WPT is an *excise* tax.

Historically an excise tax applies to production, not land. Charles I, King of England, had a civil war on his hands in 1643 and too little money. Land and houses already were taxed to the hilt, so Charles taxed everything produced in England, calling this new source of funds an excise tax. The King lost his head as well as his crown, but excise taxes, meant to be temporary, remain today.

"The Windfall Profits Tax should never have been applied to royalty owners. Before Congress makes this tax permanent, royalty owners should be exempted. Our graduated income tax takes care of their increased incomes." —Carl T. Curtis, former U.S. senator.

The framers of our Constitution were cautious about excise taxes. Apply them only to "articles of consumption," said Alexander Hamilton. The assumption is that if taxes make merchandise too high, consumers will quit buying. Thus the tax becomes self-limiting. But the Windfall Tax can never be self-limiting as long as Congress is free to extend it.

What does "production" mean? As a farmer you understand the growing of crops and raising of livestock as production. But what about oil and gas severed from land you have spent your life caring for? It is not production but a capital asset because the supply is exhaustible, finite, depletable.

Former Sen. Carl T. Curtis (R., Neb.), who spent 28 years on congressional tax-writing committees, says: "A royalty payment is not recurring income which can be generated year after year; it is proceeds from the sale of a principal asset."

Why should you be concerned? The search for energy will spread to more and more farmsteads—maybe yours. Experts say another 13 million likely will become royalty owners as exploration intensifies. Already many of the estimated 2.5 million U.S. royalty owners are farmers and ranchers, as you know.

In our extravagant society there will always be growing demand. Hence there will be more shortages of oil. The search will spread to more and more farmsteads. It may well spread to yours.

A survey for NARO found 73% over age 61; 45% draw Social Security; 27% are widows. This is one reason why the National Cattlemen's Association, American Farm Bureau and American Agriculture Movement are working to eliminate the Windfall tax. Ending the tax also is a primary goal of NARO, which uses $50 membership dues to educate the public and lobby Congress. Its address: National Association of Royalty Owners, P.O. Box C, Ada, Okla. 74820.

I urge you to write your representatives in Congress, protesting this excessive taxation of landowners and threat to their property rights. If you would like to join a small group of landowners opposing the Windfall Profits Tax behind the scenes in Washington, send your name, address and telephone number to the author: Archie M. Smith Jr., Meredyth Vineyards, P.O. Box 347, Middleburg, Va. 22117. ◁

Mr. ANTHONY. Thank you very much, Ms. Barrick. Your comment about what your son Frank told you reminds me of a definition that I recently read about guts. The definition of guts is grace under pressure. I think that your testimony today has typified grace under pressure.

Welcome to Washington, D.C. I think it is very important for people like you and Ms. Gazzaway, the people who are directly affected by the small royalty owners provision, come to Washington so Members of Congress like Mr. Peter Peyser and 80 cosponsors of a piece of legislation that has been introduced to take back what you achieved in 1981 can understand that this statement that cuts in windfall profits tax constituted nothing less than a massive giveaway to a well-heeled industry is incorrect.

I think the two of you typify that that statement is not true, that there is a great deal of misunderstanding about the oil industry, about the effect of the tax, and I certainly welcome you before this committee, and your courage to come and testify is to be admired.

Mr. Curtis. Mr. Chairman?

Mr. ANTHONY. Yes.

Mr. CURTIS. We have two members of our Legislative Committee who have statements to insert in the record. Mr. Richard Short has a statement and Mr. Archie Smith, Jr. has an excellent article that he has written that appeared in the Farm Journal.

I rise to suggest that we would like, if it pleases the chairman, to have them inserted following the testimony of Ms. Barrick.

Mr. ANTHONY. Without objection, the statements will be inserted in the record following Ms. Barrick's testimony.

Mr. Curtis, thank you very much for bringing that to our attention.

Mr. Stafford, you said that you had heard a rumor. I just want you to know that the rumor is true. It is H.R. 4460. It has got 80 cosponsors. The principal architect of the legislation testified earlier today, I don't know if you were here——

Mr. STAFFORD. Yes, I was.

Mr. ANTHONY [continuing]. To hear his testimony.

But if you and your two guests with you happen to have time before you have to go back to Oklahoma, I think it would be a very educational experience to call Mr. Peyser, ask him for an office appointment, and see if he thinks those two ladies represent a well-heeled industry.

I did ask some questions of him and ask if he was willing to make some amendments to his legislation, if he can be convinced that that was the case.

He at least seemed charitable in his intentions at the time, so I would take the opportunity if I were you to maybe go by and visit with him.

Mr. STAFFORD. Excellent suggestion, Mr. Chairman, thank you.

Mr. ANTHONY. Mr. Stark?

Mr. STARK. I have no questions, Mr. Chairman.

Mr. ANTHONY. Mr. Pickle?

Mr. PICKLE. Thank you, Mr. Chairman.

I want to express my appreciation to the panel again for being with us.

I particularly want to pay my respects to the two ladies who testified. A lot of people think that people who receive royalty owners checks are just those who want to add a little more to their billfold, get a big car and ride around.

A lot of people forget the fact that most of the royalty owners are little people living out on a farm, who received property from their family, and the windfall exemption means a great deal to them.

That ought to be brought out. I am glad that you have done it.

Let me say also before I get into some of my questions, that last year when we passed the tax package in conference, agreement was finally reached that we would give certain tax benefits in the energy, area—particularly in oil and gas, among other things.

When the decision was finally reached to give those benefits, it was not to give them to the big oil companies, but the bulk of that relief was to go to the royalty owners, and to the independent producers who discover 90 percent of new oil.

That was a good decision. What we did was the right thing; now we need to protect it.

Your testimony here adds to the fact that we would hurt little people if we took this royalty owners' exemption away.

I hope we won't do it.

I want to ask, if I may, Mr. Chairman; Mr. Coffman, you pointed out to us the importance of the intangible drilling costs, what it means to your operation.

As I said earlier, I know you are one of the major drillers in our State. Could you give us more specifics as to the importance of these intangible drilling costs?

How does it affect your business, if IDC's were included as a preference item, how would it affect your operation? Can you explain that to us?

Mr. COFFMAN. I will try, Mr. Pickle.

Our particular programs, over the last 2 years, 1980 and 1981, we discovered if the alternate minimum tax were in effect in those years, that our programs that we participated in as the operator and sponsor would have been $5 million smaller, assuming the people would have reinvested the money they made in the exploration, which almost all of them do.

We think it would have been a direct drop of $5 million over those periods of time.

Mr. PICKLE. Can you tell me what that relates to in percentage of drilling or percentage of operations?

Mr. COFFMAN. I would say that amount or accounts for 10 to 12 less wells that would have been drilled.

Mr. PICKLE. I have been told that if the excess of the intangible drilling costs were incorporated into the minimum corporate tax, that would reduce your drilling budget by about 15 percent and you would reduce your exploration between 20 and 30 percent overall, not just in the specific number of wells.

Is that correct?

Mr. COFFMAN. I think it could be in excess of that, Mr. Pickle, because of the rig count dropping, we have several factors contributing to that and an additional tax at this time could be the straw that broke the camel's back, so to speak.

Mr. PICKLE. If all intangible drilling costs were included, not just the excess, drilling and exploration would really be cut back.

Of course, if you capitalized it, I guess you would just close the drilling operation down.

Mr. COFFMAN. There is some talk of that now. A lot of independent operators have their projects on hold or have closed because of economic conditions.

We think that the tax on the intangibles would just, as I say, maybe it is the last straw.

Mr. PICKLE. I understand from what Mr. Vinson said—perhaps in your testimony, too—that you have 700 to 800 stacked rigs in Texas right now. Is that in Texas or is that nationwide?

Mr. VINSON. Nationwide.

Mr. PICKLE. What was your total?

Mr. VINSON. For the nationwide, it would be somewhere over 800 rigs now stacked that were recently making holes.

Mr. PICKLE. I know we have rigs stacked in Texas. We do a great deal of the drilling but I assume, then, that this is the same throughout the country.

Mr. VINSON. That's correct.

Mr. PICKLE. If we have a 20-percent reduction in crude oil prices now, it is estimated that they might go lower. Do you want to venture what it might drop to? Or do you hesitate to be the one to say?

Mr. COFFMAN. Many people, including Texaco, believe the price of crude may go to $15. I hope and certainly don't believe that, but certainly that is a contributing factor in our rig count.

Mr. PICKLE. But if we have a 20-percent reduction in prices now, and if drilling already is being reduced some 20 percent, if you included the IDC's as a preference item—that is, in the tax base—then your drilling would be cut down 30 to 40 percent, possibly; is that correct?

Mr. COFFMAN. That's correct. Perhaps even more than that.

I think it is important for us to understand that at one time, we were getting $39.50 for our oil; now we are getting $28 for the oil. That is what our net is.

That constitutes a 29-percent reduction in price, but costs have gone up from 1978, costing $350,000 for a well; it is now 800 for that same well.

So you can see the lower oil prices, higher costs, then the uncertainly in the investor market, as far as capital being raised, coupled with the tax decrease last year, the maximum rate on individuals from 70 percent down to 50 percent, the future of the oil business certainly is one that needs ginning up a little, not more tax.

Mr. PICKLE. If you have a reduced price and added costs, then the outcome has to be much less drilling.

Mr. COFFMAN. That's right.

Mr. PICKLE. We ought to understand that before we take any action.

Mr. Coffman, there is a lot of talk that the oil and gas people take advantage of tax loopholes and just pay the minimum in taxes.

How do you feel about that? Is that an accurate statement?

Mr. COFFMAN. Well, I think that is a general belief and I guess I had fallen victim to that myself until I did some research myself.

We paid, in 1981, almost 20 percent, 19.7 percent of our gross revenues from oil and gas in terms of other taxes, taxes other than Federal income tax.

We paid—our investors' programs yielded a return of $67 million on a gross basis in 1981 and we paid $13½ million in windfall profits tax and sales tax, ad valorem tax, lease-use tax, and severance taxes. In addition to our Federal income tax, that is.

In addition to that, we took and spent 160 percent of our revenues from oil and gas on plowing it back into the oil business in terms of drilling or leases.

We have a large lease-hold inventory which we expect to drill up and that assumed a favorable investment climate.

We need that investment, not a tax increase, which would definitely decrease the amount of funds available for drilling in our programs.

Mr. Pickle. Well, it sounds to me like you do make a very major contribution in the way of taxes and you are not avoiding them. We do need the production and we ought not to take action that would cut production because our Nation desperately needs it.

I thank you for your statement.

Mr. Chairman, thank you very much for the time.

Mr. Anthony. Mr. Russo, you may inquire.

Mr. Russo. Thank you, Mr. Chairman.

I was not going to enter into the debate, but as a result of some of the comments made in the last questions, I would like to ask the Independent Producers Association, how much has the income of Independent Producers increased since 1975 to the present time?

Mr. Vinson. Well, the price of crude oil went from 1971 level of $3 a barrel, slowly escalated up to where certainly the highest category was near $[illegible]0 a barrel.

There are other categories lower-priced than that from $11 to $15 a barrel.

Mr. Russo. I believe there has been one very well-researched paper that has been done on it that indicates that incomes of the independent producers from 1975 to 1980 have increased by 510 percent.

So there has been a significant increase in the incomes of independent producers, and I always like the other side of the coin to be told because I don't think you are doing that bad.

Stripper wells, as I understand, were decontrolled as early as 1976, so they would be getting full world market prices and we all understand that OPEC is setting the figure, having nothing to do with the competitive nature of the marketplace.

There are a lot of things that have to be weaved into this whole equation that we are talking about. I believe that some of the things that we have done haven't been all that right, but some of the things we have done have been proper, taking into consideration the increases that have come forward in the oil industry. I have a difficult time having a great deal of sympathy for people whose incomes have gone up 510 percent in a period of time when most other people's purchasing power has gone down.

I can appreciate what Ms. Gazzaway and Ms. Barrick have talked about and that is something we ought to look at.

But some of the other comments made—I think the fact that price increases have been allowed to go up unrestrained and set by OPEC is something we have to take into consideration.

When you say, Mr. Coffman, that the price has gone from $40 to $29 a barrel, and that impacts on you, sure it does; it means you won't get that added extra profit that you would normally get for doing nothing more than drilling, just so long as OPEC sets the price at $40, or even $50.

But I would suspect at $29 a barrel, you are not hurting, are you?

Mr. COFFMAN. Our program is on a relative basis will decline, I think. I will point out a statistic that IPAA mentioned, that is the rig count is declining dramatically and only after we had this favorable economic condition existing with the high price for oil have we stopped the decline of production in this country for the first time in recent history did we have production equal to our consumption rates.

So I think that is important that we keep that in mind.

Mr. RUSSO. You know I certainly think that we ought to do all we can to be energy sufficient and do all we can to produce and conserve.

If I remember my days on the Commerce and Energy and Power Committee, the oil people coming before us would say $10, certain things would happen, $15, $40 a barrel, none of those things happened.

I just want to have the other side of the story on the record.

Mr. VINSON. I wonder if I could respond, Mr. Chairman.

Mr. ANTHONY. Yes.

Mr. VINSON. It is true that prices have increased. A statistic that has remained fairly constant the last several years is the independent segment have spent 105 percent of their revenue putting it into drilling costs.

And we drill 90 percent of the wildcats, that is, the wells that look for new oil and gas. So it is not like the independent producers are putting this money in their hip pocket and going on vacation.

The inclined curve on an increased exploration expenditure has tracked right with the price, and as Mr. Coffman pointed out, we are now, we found the same amount of crude oil reserves that we produced, so we have turned around the increased dependence on imports.

Mr. RUSSO. That is a smart business investment. If I was getting the return you were getting on your money, I would put 105 percent back in to find as much as I could, too.

Mr. VINSON. The final point is that the costs have tracked up with the price so the profit has remained about constant.

Mr. RUSSO. OK.

Mr. PICKLE. Would the gentleman yield?

Mr. RUSSO. Be more than happy to yield to my good friend from Texas.

Mr. PICKLE. I don't think there is any argument that oil and gas people are in the business to try to make a profit.

They risk a great deal of money and they can lose a barrel of it mighty quick.

I don't think anybody can question the fact that the better the price, the more incentive there is for people to get into the business.

That is what has happened because people felt it was and is worth it. Thank goodness that is the case.

But I think we have to recognize there is a leveling-off period and that it sometimes goes in reverse. Mr. Coffman just said he had moved into Austin to do drilling in the central Texas area and you started off with a group of what, three or four people?

And you had how many total?

Mr. **Coffman**. We have 180.

Mr. **Pickle**. Now, is your drilling still going on in the same pace in that area?

Mr. **Coffman**. No, sir.

Mr. **Pickle**. How much has it slacked off?

Mr. **Coffman**. It has probably doubled, I would say, 25 to 30 percent right now.

Mr. **Pickle**. So there is that much of a reduction. Now, do you still have your basic costs continuing?

Mr. **Coffman**. Our costs have gone up.

Mr. **Pickle**. Gone up?

Mr. **Coffman**. Yes, almost three times since we started in 1978.

Mr. **Pickle**. I can see, then, that it seems on the surface like you are doing fine, but there is more to it than just the price.

Mr. **Russo**. To clarify the record, if I may reclaim part of my time.

I am not against profits, Jake, you know that. I think part of the problem is when somebody outside the competitive marketplace is setting the price that the consumers in this country have to pay, that is when the Congress got into it.

No one is against anyone making a profit and I am the last one in the world to be against that.

Mr. **Anthony**. I thank the members of the committee for their diligence and also my thanks to the members of the panel.

I would like the record to reflect that Mr. Vinson also is representing the royalty owners and independent gas producers of Arkansas in his prepared testimony.

Mr. Vinson, that association is headquartered in my home county of Union County. It is an association that I have worked closely with, along with Mr. Stafford from the adjoining State of Oklahoma, inasmuch as my district does border the congressional district that Mr. Stafford lives in.

I think all of you have made very excellent presentations. I don't have to tell you that you are in a difficult political battle, as you can see from Mr. Peyser's bill with 80 cosponsors, and there are numerous other bills that have been introduced in one form or another and as the new figures for the deficit come out, we all realize we are gong to be scrambling for revenues and it does, Ms. Gazzaway, appear that all means—means that it has to be ranked No. 1 when you start looking for revenue.

So the fight is on. You are to be complimented for having the courage, the guts of a government mule in this case, Ms. Barrick, to come up and give your testimony.

Ms. **Barrick**. Thank you.

Mr. ANTHONY. It will be very helpful to the members of this committee and the Congress as we deliberate on further tax measures that come before the committee.

As one member, I can only say that I pledge to work with you to see that anything that the committee does would be fair and would distribute the tax burden in a fair way.

With that, our thanks to you for your presentations.

The committee will be in recess until tomorrow morning.

[Whereupon, at 12:54 p.m., the committee was adjourned, to reconvene at 9:30 a.m., Tuesday, April 6, 1982.]

ADMINISTRATION'S FISCAL YEAR 1983 ECONOMIC PROGRAM

TUESDAY, APRIL 6, 1982

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met at 9:33 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. The committee will come to order.

Our first witness is Governor Garrahy of Rhode Island. Welcome to the Committee on Ways and Means, Governor. It is always a pleasure to have you testify.

We look forward to your sharing your views with us. I am sorry that my colleague, Frank St Germain, with whom I came to Congress, is not here. However, I am sure that he would express his good wishes.

If you would identify yourself for the record, you may proceed.

STATEMENT OF HON. J. JOSEPH GARRAHY, GOVERNOR OF RHODE ISLAND, AND CHAIRMAN, COALITION OF NORTHEASTERN GOVERNORS

Governor Garrahy. Mr. Chairman, I am Joseph Garrahy. I saw Congressman St Germain this morning and he sends his best to you, also, and it was very kind of him to make this essential arrangement for me to come down.

I might like to point out that it is unusual to have so many Rhode Islanders at a hearing, but we have probably the largest number of Rhode Islanders to attend a Ways and Means Committee hearing.

There are probably 50 or 60 students from Project Closeup at this committee hearing today. They are outstanding Rhode Island students attending a great program, Project Closeup.

I am pleased, Mr. Chairman, to appear to discuss proposed changes in the tax-exempt industrial development bond program, or IDB's, as they are commonly referred to.

I am here not only as the Governor of Rhode Island, but also in my capacity as chairman of the Northeast Governors.

This coalition of Governors comprises the New England States, New Jersey, New York, and Pennsylvania, and it has as its mission the revitalization of the Northeastern economy.

I understand that you heard testimony last week from Governor Bond on behalf of the National Governors' Association and from my colleague, Governor Carey of New York, regarding this issue.

Let me say at the outset that the Northeast Governors fully support the National Governors' position on industrial development bonds and the leadership role that Governor Bond has played.

The proposal which I recommend as an alternative to the administration's tax proposal is in concert with the National Governors' position, but it sets forth in more specific detail reforms in the bond program.

When the Northeastern Governors met here in Washington a few weeks ago, industrial development bonds were a major topic of concern and discussion.

The reason for this was simple. Small-issue industrial development bonds are the cornerstone of our efforts to finance and promote job creation and economic recovery in the Northeast.

Together, the nine Northeastern States account for nearly 37 percent of the total national volume of these bonds—a figure which reflects the critical importance of industrial revenue bonds as a capital formation and a business financing tool in the hard-pressed industrial States of our region.

The Washington debate on IDB's has tended to focus on the revenue effects, the impact on the bond market, and a handful of highly publicized abuses.

While these are all important factors for Congress to consider, they should not eclipse the fundamental fact that industrial development bonds have produced new jobs and new industry in areas experiencing economic hardship and stagnation.

Furthermore, we are all wrestling with how this industrial revenue bond program, so essential for our economic revitalization, can be reformed to eliminate abuses while preserving and strengthening the program's positive job creation benefits.

When I met with my CONEG colleagues in February, we adopted a six-point proposal to achieve those objectives. Our proposal is a good-faith effort to put together a constructive, responsible reform program that does eliminate the abuses, while targeting assistance to distressed areas, insuring that small business gains access to lower cost financing, promoting the growth of high-technology firms, and providing for public notice and annual reporting of all bonds issued.

Mr. Chairman, you will find that these recommendations parallel, in several respects, the proposal advanced by the Oversight Subcommittee of this committee in July of last year.

The northeast proposal is designed to eliminate controversial projects as urged by your Oversight Subcommittee, and to issue tax-exempt securities for needed economic development projects.

The industrial development bond program is one I know well. In 1973, the Navy announced a series of cutbacks. My State was devastated, absorbing more than half of the nationwide impact.

We lost more than 6 percent of our gross State product, driving our unemployment to depression-like proportions. At that time, I was Lieutenant Governor then, and in response to this Federal action, I chaired the economic renewal task force that authored an aggressive and comprehensive recovery program, the nucleus of which is its financing entity, the Port Authority and Economic Development Corporation, which I chair.

We established a conservative program that has turned down many projects that do not meet our strict policy of permitting IDB's only for manufacturing projects or corporate headquarters.

Commercial projects are allowed only as an inducement for private capital investment in areas where urban resources are unwilling to invest.

The results of these restrictions is that 90 percent of our projects are manufacturing.

Since I became Governor in 1977, we have financed, in our State, $247 million in 103 projects and created or retained 23,700 jobs.

Thus, the program has impacted almost 7 percent of all Rhode Island jobs at an investment rate of about $10,000 per job created or retained, a figure comparable to the Economic Development Administration's measure of effectiveness in its programs.

I should point out that these 23,700 jobs represent Rhode Island workers who are productively employed, paying taxes and not demanding State or Federal social service expenditures.

In 1981, we initiated a small manufacturers financing mechanism utilizing IDB's with a guarantee provided by another State agency.

Of the 48 companies receiving IDB financing in 1981, almost 20 percent were small manufacturers whose financing needs were substantially less than $1 million. These small manufacturers created or retained 640 jobs.

Rhode Island is not alone in the successful use of this program to spark new growth and economic development:

Since 1973, the Connecticut Development Authority has approved an estimated $1.1 billion in IDB-financed loans to roughly 440 companies.

According to Gov. Bill O'Neill, these loans have resulted in the creation of 39,000 new jobs, the retention of 65,000 existing jobs, and the construction or renovation of more than 26 million square feet of building space.

In New Jersey the State economic development authority has issued roughly $2.5 billion.

In the past 3 years, the Massachusetts Industrial Finance Agency has financed 870 projects totaling roughly $1.2 billion in new investment, and accounting for more than 47,000 new permanent jobs, 18,000 construction jobs, and 12.5 million square feet of new industrial space.

Similar success stories and impressive statistics can be recited for virtually every State in our region.

Would these jobs and these investments have occurred in the Northeast without IDB's? In my opinion, the answer to that question is a definite "No."

Bob Patterson, director of the Massachusetts Industrial Finance Agency, can tell you the results of his survey of Massachusetts firms, and we have conducted our own study of businesses using IDB's in Rhode Island.

In the 3-year period, 1979 through 1981, Rhode Island State agencies approved 75 manufacturing projects for industrial development bond financing of $124.1 million.

Nearly all of these projects were for small companies, as evidenced by average financing per project of $1.6 million. Six projects were financed at $5 million or more; 20 at under $1 million; and the balance between $1 and $5 million.

Our recent survey of our companies determined the importance of IDB financing to their investment projects. The response of these companies demonstrates conclusively that IDB financing is essential for new job-generating investment in manufacturing firms.

Two-thirds of the 75 companies responded to the survey. Of these 50 projects, 38—that is 76 percent—would not have built a new plant, expanded an existing facility, or invested in new machinery and equipment without IDB financing; of the 12 projects which would have used conventional financing, 7 would have been delayed or reduced in size if the IDB's had not been available.

These 50 firms have a total employment of over 6,900, or an average of 139 per firm, and represent about 5 percent of all the manufacturing employment in Rhode Island.

Our survey thus found what the Congressional Budget Office found in 1978 and again in 1979, that the IDB program is one that finances the growth of small business, that sector of the economy alive with the entrepreneurial spirit that holds the important key to the future strength and competitiveness of our national economy.

In my view, these facts and figures tell only part of the story. With interest rates at their current historic highs, I can say with confidence that without IDB's, industrial expansion and new construction in my State would be at a virtual standstill.

We know that you have heard from Governor Bond and will hear from others today regarding the severe damaging effects which the administration's tax proposals would have on State and local IDB programs.

The administration's IDB proposals go far beyond what is needed to clean up abuses in this program, and would have the net effect of eliminating this form of financing for legitimate economic development projects.

The Coalition of Northeastern Governors strongly opposes the broad-scale attack on tax-exempt financing contained in the Administration's tax proposals.

However, the CONEG Governors believe that responsible Federal reforms are needed in the IDB program.

Mr. Chairman, and committee members, the proposal of the Northeastern Governors for small-issue industrial development bonds would:

One, eliminate the use of IDB's for controversial projects. The principal and foremost objective of the CONEG proposal would be to eliminate the use of small-issue IDB's in the financing of certain controversial facilities.

With the exception of permitting the financing of certain defined commercial projects to be located within economically distressed areas, the CONEG proposal would prohibit the use of IDB's to finance all commercial, recreational, or entertainment facilities.

We do not believe IDB's should be used for fast-food franchises. We do not believe IDB's should be used for nightclubs. We do not believe IDB's should be used for massage parlors. We do not believe

IDB's should be used for tennis courts or golf courses or suntan facilities.

In fact, our proposal is even more restrictive than the Metzenbaum amendment, which was passed by the Senate last year.

We would also target assistance to distressed areas. Under this proposal, it would allow the States to address IDB's to finance carefully defined commercial projects in order to stimulate the redevelopment of economically distressed areas.

Under the CONEG proposal, States would be allowed to issue IDB's to induce private enterprises to construct new facilities and rehabilitate existing structures located in eligible areas.

The CONEG proposal would restore the rights of States to issue umbrella IDB's in connection with financed programs specifically designed to make available low-cost loans to small businesses seeking to finance modest projects.

Umbrella bonds were prohibited by Revenue Ruling 81-216 and in the subsequent IRS Regulation LR264-81.

The CONEG proposal would provide an exception to the IRS ban on umbrella bond issues so as to enable States to continue to issue IDB's under umbrella programs.

We would also eliminate disincentives for research and development. Under present law, IDB's are often unavailable to high-technology businesses which rely heavily on research and development expenditures.

Again, the CONEG proposal would provide that certain research and development expenditures annually incurred by such companies would not be included when calculating the capital expenditure limitations in connection with the issuance of IDB's.

We would require public review. The CONEG proposal would mandate certain public notice requirements be met by State and local development authorities before issuing IDB's.

Finally, we would require an annual reporting on IDB use. Our proposal would require all State and local development authorities which issue IDB's during a calendar year to file an annual report with the Treasury Department.

Such a report would provide the Federal Government with pertinent facts regarding the industrial development bond programs within each State.

Specifically, the reports would set forth the aggregate amount of IDB's issued during the reporting period, the number of projects financed, a brief description of the projects and a statement of the number of jobs created or preserved by reason of each financing.

It is my understanding that two of these provisions—namely, the list of ineligible uses and the research and development provisions—are included in H.R. 4717, the miscellaneous tax bill currently in conference between the Senate and the House.

The enactment of those two provisions, together with the additional changes we are suggesting, would provide a workable framework for State and local IDB programs to go forward.

Mr. Chairman and members, we all share a deep concern over our recessed national economy and the real pain it causes our unemployed workers and their families, the small business person driven to bankruptcy, the human effects too often masked by statistics.

I can tell you, however, that in our State of Rhode Island, we had been making significant economic progress. We were finally on the right track.

Our unemployment rate, well above the national average for decades, dropped below it during 1980 and 1981, largely, as I have shown, through the use of industrial development bonds.

Now, with this deepening recession, we again have double-digit unemployment rates in our State.

This administration is calling for federalism, for giving the States greater responsibility. Dismantling the effectiveness of industrial development bonds and other revenue bond programs now—programs that generate jobs, that leverage significant private investment, that provide small businesses with reasonable financing and allow them to grow—would do a disservice to our economy and to our people.

While I have limited my remarks to industrial development, I would like the committee to know that the Governors are very concerned, and as Governor, I pointed out about the administration's attack on the tax-exempt program.

Mr. Chairman, I thank you and the members of this committee for the opportunity to appear here.

I know that you will give our proposals serious consideration.

[The prepared statement follows:]

STATEMENT OF HON. J. JOSEPH GARRAHY, GOVERNOR OF RHODE ISLAND, ON BEHALF OF THE COALITION OF NORTHEASTERN GOVERNORS

Mr. Chairman, members of the Committee, I am pleased to appear here today to discuss proposed changes in the tax-exempt industrial development bond program. I am here this morning not only as Governor of Rhode Island -- the biggest little state in the union -- but also in my capacity as chairman of the Coalition of Northeastern Governors (CONEG).

I understand you heard testimony last week from Governor Bond, on behalf of the National Governors' Association, and from my colleague, Governor Hugh Carey of New York, regarding this issue. Let me say at the outset that the CONEG Governors fully support the NGA position on IDBs, and the leadership role Governor Bond has played on behalf of all of our states. But we in the Northeast have some unique regional concerns in this area, as well as some positive recommendations for specific reforms in the IDB program.

When the northeastern Governors met here in Washington a few weeks ago, industrial development bonds were a major topic of concern and discussion. The reason for this is simple: small issue industrial development bonds are a cornerstone of our efforts to finance and promote job creation and economic recovery in the Northeast. Together, the nine northeastern states account for nearly 37 percent of the total national volume of these bonds -- a figure which reflects the critical importance of IDBs as a capital formation and business financing tool in the hard-pressed industrial states of our region.

The Washington debate on IDBs has tended to focus on revenue effects, impact on the bond market, and a handful of highly publicized abuses. While these are all important factors for Congress to consider, they should not eclipse the fundamental fact that IDBs have produced new jobs and new industry in areas experiencing economic hardship and stagnation. Furthermore, we all have wrestled with how this IDB program, so essential for our economic revitalization, can be reformed to eliminate abuses while preserving and strengthening the program's positive job creation benefits.

When I met with my colleagues in February we adopted a six-point proposal to achieve those objectives. Our proposal is a good faith effort to put together a constructive, responsible reform program that does eliminate the abuses, while targeting assistance to distressed areas, ensuring that small business gains access to lower cost financing, promoting the growth of high technology firms, and providing for public notice and annual reporting of all bonds issued.

Mr. Chairman and Committee members, you will find that these recommendations parallel, in several respects, the proposal advanced by the Oversight Subcommittee of this Committee in July of last year.

The Industrial Development Bond program is one I know well. In 1973, the Navy announced a series of cutbacks. My state was devastated, absorbing more than half of the nationwide impact. We lost more than 6 percent of our gross state product, driving our unemployment to depression-like proportions. I was Lieutenant Governor then and, in response to this federal action, I chaired the economic renewal task force that authored an aggressive and comprehensive recovery program, the nucleus of which is its financing entity, the Port Authority and Economic Development Corporation, which I chair. We established a conservative program that has turned down many projects that do not meet our strict policy of permitting IDBs only for manufacturing projects or corporate headquarters. Commerical projects are allowed only as an inducement for private capital investment in areas where urban capital resources are unwilling to invest. The results of these restrictions is that 90 percent of our projects are manufacturing.

Since I became Governor in 1977, we have financed $247 million in 103 projects and created or retained 23,700 jobs. Thus, the program has impacted almost 7 percent of all Rhode Island jobs at an investment rate of about 10,000 per job created or retained, a figure comparable to the Economic Development Administration's measure of effectiveness in its programs. I should point out that these 23,700 jobs represent Rhode Island workers who are productively employed, paying taxes and not demanding state or federal social service expenditures.

In 1981 I initiated a small manufacturers financing mechanism utilizing IDBs with a guarantee provided by another state agency. Of the 48 companies receiving IDB financing in 1981, 8 were small manufacturers whose financing needs were substantially less than $1 million. These small manufacturers created or retained 640 jobs.

Rhode Island is not alone in the successful use of this program to spark new growth and economic development:

-- Since 1973, the Connecticut Development Authority has approved an estimated $1.1 billion in IDB-financed loans to roughly 440 companies. According to Governor Bill O'Neill, these loans have resulted in the creation of 39,000 new jobs, the retention of 65,000 existing jobs, and the construction or renovation of more than 26 million square feet of building space in his state.

-- In New Jersey, the state Economic Development Authority has issued roughly $2.5 billion in IDB financing since 1974, which has stimulated total investments of more than $3.4 billion, more than 66,000 permanent jobs created or retained, and roughly 38,000 construction jobs in a seven-year period.

-- In the past three years, the Massachusetts Industrial Finance Agency has financed 870 projects totalling roughly $1.2 billion in new investment, and accounting for more than 47,000 new permanent jobs, 18,000 construction jobs, and 12.5 million square feet of new industrial space.

Similar success stories and impressive statistics can be recited for virtually every state in our region.

Would these jobs and these investments have occurred in the Northeast without IDBs? In my opinion, the answer to that question is a definite "no."

Bob Patterson, Director of the Massachusetts Industrial Finance Agency, can tell you the results of his survey of Massachusetts firms, and we have conducted our own study of businesses using IDBs in Rhode Island. In the three-year period, 1979 through 1981, Rhode Island state agencies approved 75 manufacturing projects for Industrial Development Bond financing of $124.1 million. Nearly all of these projects were for small companies as evidenced by average financing per project of $1.6 million. Six projects were financed at $5 million or more; twenty at under $1 million; and the balance between $1 million and $5 million.

Our recent survey of these 75 companies determined the importance of IDB financing to their investment projects. The response of these companies demonstrates conclusively that IDB financing is essential for new job generating investment in manufacturing firms.

Two-thirds of the 75 companies responded to the survey. Of these 50 projects, 38 -- that's 76 percent -- would not have built a new plant, expanded an existing facility, or invested in new machinery and equipment without IDB financing; of the twelve projects which would have used conventional financing, seven would have been delayed or reduced in size if the IDB's had not been available.

These 50 firms have a total employment of 6,974, or an average of 139 per firm, and represent about 5 percent of all the manufacutring employment in Rhode Island.

Our survey thus found what the Congressional Budget Office found in 1978 and 1979, that the IDB program is one that finances the growth of small business, that sector of the economy alive with the entrepreneurial spirit that holds the key to the future strength and competitiveness of our national economy.

In my view, these facts and figures tell only part of the story. With interest rates at their current historic highs, I can say with confidence that without IDBs, industrial expansion and new construction in my state would be at a virtual standstill.

You have heard from Governor Bond and will hear from others today regarding the severe damaging effects which the Administration's tax proposals would have on state and local IDB programs. The Administration's IDB proposals go far beyond what is needed to clean up abuses in this program, and would have the net effect of eliminating this form of financing for legitimate economic development projects. The Coalition of Northeastern Governors strongly opposes the broad-scale attack on tax-exempt financing contained in the Administration's tax proposals.

However, the CONEG Governors believe that responsible federal reforms are needed in the IDB program.

Mr. Chairman and Committee members, the proposal of the Northeastern Governors for small issue industrial development bonds would:

1. Eliminate the Use of IDBs for Controversial Projects

The principal and foremost objective of the CONEG proposal would be to eliminate the use of small issue IDBs in the financing of certain controversial facilities. With the exception of permitting the financing of certain defined commercial projects to be located within economically distressed areas, the CONEG proposal would prohibit the use of IDBs to finance all commercial, recreational or entertainment facilities.

We do not believe IDBs should be used for fast food franchises. We do not believe IDBs should be used for night clubs. We do not believe IDBs should be used for massage parlors. We do not believe IDBs should be used for tennis courts or golf courses or sun tan facilities. In fact, our proposal is even more restrictive than the Metzenbaum amendment.

2. Target Assistance to Economically Distressed Areas

The CONEG proposal would allow states to issue IDBs to finance carefully defined commercial projects in order to stimulate the redevelopment of economically distressed areas. Under the CONEG proposal, states would be allowed to issue IDBs to induce private enterprises to construct new facilities and rehabilitate existing structures located in eligible areas. The maximum amount of IDBs that could be issued for a project in the economically distressed areas would be revised from $10,000,000 to $15,000,000. In addition, to aid these distressed areas, our proposal would expand the scope of projects which could be financed with IDBs to include commercial office buildings, corporate headquarters, restaurants and retail stores.

3. Allow for Issuance of Umbrella Bonds for Small Business

The CONEG proposal would restore the rights of states to issue umbrella IDBs in connection with financed programs specifically designed to make available low-cost loans to small businesses seeking to finance modest projects. Umbrella bonds were prohibited by Revenue Ruling 81-216 and in the subsequent IRS Regulation LR264-81. The CONEG proposal would provide an exception to the IRS ban on umbrella bond issues so as to enable states to continue to issue IDBs under umbrella programs provided (1) all the projects sought to be financed under the umbrella bond issue are located within a state's borders, and (2) the maximum loan for any project under the umbrella program does not exceed $1,000,000.

4. Eliminate Disincentives for Research and Development

Under present law, IDBs are often unavailable to high technology businesses which rely heavily on research and development expenditures. The CONEG proposal would provide that certain research and development expenditures annually incurred by such companies would not be included when calculating the capital expenditure limitations in connection with the issuance of IDBs.

5. Public Review Requirements

The CONEG proposal would mandate certain public notice requirements be met by state and local development authorities before issuing IDBs. Specifically, legislation should require that development authorities give public notice of proposed IDB-financed projects and that final decisions regarding the issuance of IDBs be adopted at open public meetings.

6. Annual Reporting on IDB Use

Our proposal would require all state and local development authorities which issue IDBs during a calendar year to file an annual report with the Treasury Department. Such a report would provide the federal government with pertinent facts regarding the industrial development bond programs within each state. Specifically, the reports would set forth the aggregate amount of IDBs issued during the reporting period, the number of projects financed, a brief description of the projects and a statement of the number of jobs created or preserved by reason of each financing.

It is my understanding that two of these provisions -- namely the list of ineligible uses and the research and development provisions -- are included in H.R. 4717, the miscellaneous tax bill currently in conference between the Senate and the House. The enactment of those two provisions, together with the additional changes we are suggesting, would proivde a permanent and workable framework for state and local IDB programs to go forward.

Mr. Chairman and members, we all share a deep concern over our recessed national economy and the real pain it causes our unemployed workers and their families, the small business person driven to bankruptcy, the human effects too often masked by statistics.

I can tell you, however, that in Rhode Island we had been making significant economic progress. We were finally on the right track. Our unemployment rate, well above the national average for decades, dropped below it during 1980 and 1981, largely, as I have shown, through the use of industrial development bonds. Now, with this deepening recession, we again have double-digit unemployment rates.

The administration is calling for federalism for giving the states greater responsibility. Dismantling the effectiveness of industrial development bonds and other revenue bond programs now -- programs that generate jobs, that leverage significant private investment, that provide small businesses with reasonable financing and allow them to grow -- would do a disservice to our economy and to our people.

I thank you, Mr. Chairman and members of the Committee, for this opportunity to appear before you and I know you will give very serious consideration to our responsible and responsive reform proposal.

I have with me James Skeffington, bond counsel for Rhode Island, Arthur Markos, Chairman of the CONEG Advisory Board, and David Arnold, our Executive Director. I will be pleased to respond to any questions you have.

Thank you.

Chairman ROSTENKOWSKI. Thank you very much, Governor. It is a pleasure to have you join in our discussions.

As you know, we have been wrestling with this problem over a number of years. I hope that we can resolve this problem when we sit down in the markup sessions.

Are there any questions of Governor Garrahy?

Mr. Anthony is recognized.

Mr. ANTHONY. Thank you, Mr. Chairman.

Just to ask a couple of questions. The abuses that you talk about, what abuses have you seen in the nine Northeastern States that you think need to be cleaned up?

Governor GARRAHY. Well, I think some of the abuses that I am personally aware of, and some I have read about, are the fact of financing national food franchises, for instance.

Mr. ANTHONY. Let's talk about that a minute.

What are some of the good uses that some of the States have used in your area that have created the various jobs that you have listed in your testimony?

Governor GARRAHY. We have a very unique program assisting small businesses. Whereas, another State agency provides for a guarantee against the use of tax-exempt financing.

We have had many businesses with under $1 million needed, which have created in the last year, in my State, almost 700 jobs.

Mr. ANTHONY. What were the typical types of industry that would be utilized?

Governor GARRAHY. We recently had one that we provided for a small manufacturer of plastic machinery.

Mr. ANTHONY. Plastic machinery. And they hire semiskilled or what?

Governor GARRAHY. I would say semiskilled employees.

Mr. ANTHONY. What would you say the rate of unemployment is among teenagers in your State?

Governor GARRAHY. In my State, I would say the rate is similar to the national rate, maybe 20 to 25 percent.

Mr. ANTHONY. Almost double what the other rate is?

Governor GARRAHY. Yes.

Mr. **Anthony**. Who is one of the largest employers of teenagers, fast-food chains.

Governor **Garrahy**. I would suspect they are.

Mr. **Anthony**. So if we discriminate against fast-food chains in the use of IDB's, could we not say we are discriminating against teenagers having an opportunity to have the State provide jobs for them in competition with semiskilled and older unemployed?

Governor **Garrahy**. I am certainly not in the position of having to say that we wanted to discriminate against younger workers, but I would point out where we have——

Mr. **Anthony**. My point is this, is not a job a job? In other words, it is my understanding that McDonald's, nationwide, employs more people nationwide than General Motors.

So why would we want to discriminate against an industry that is putting people to work when we are in the highest unemployment areas?

Governor **Garrahy**. I am not suggesting we discriminate against younger workers——

Mr. **Anthony**. You say fast-food franchises ought to be eliminated.

Governor **Garrahy**. Well, that has been——

Mr. **Anthony**. You tell all those closeup kids in the audience, what are you going to say to them as to what we will do to help find them a job?

Governor **Garrahy**. The only problem we have with that, Mr. Congressman, is some of those fast-food chains are not necessarily fast-food chains, but the shopping, large national shopping concerns that also use industrial revenue bonds are locating adjacent to other shopping centers, causing competitive situations and tax-exempt financing puts them in that situation and a diminution of jobs overall as a result of it.

Mr. **Anthony**. What about that small plastic company that gets an IDB and the adjoining town you have a private entity that puts one in with his own capital?

Isn't the one in your State or your town getting an advantage over that?

Governor **Garrahy**. I would suspect that we would.

Mr. **Anthony**. They don't have to be right side by side to have the competitive advantage if you are using the tax-exempt funding mechanism.

Governor **Garrahy**. I would expect a plastic manufacturer in another area would have access to the same financing.

Mr. **Anthony**. The only thing that bothers me in this discussion—don't take me wrong, I happen to be a strong supporter of industrial development bonds and had Arkansas not been utilizing them, you could have wrapped us and sent us off somewhere, we would have no economic growth.

But I must admit everybody comes in and talks about the abuses but the abuses they talk about are providing jobs and jobs to a large segment of the population that are unemployed and would like to have jobs.

So I guess I am having a hard time drawing the distinction between what industries should be able to utilize the bonds and what industries should not.

Just as a last question, would it be too much of a problem for you to give us a list of the projects that have been funded by the IBD's and also a list of the projects that were rejected?

Governor **Garrahy**. No, we would be happy to supply that to you, Mr. Congressman.

[The information was subsequently received:]

INFORMATION REQUESTED BY REPRESENTATIVE ANTHONY OF GOVERNOR GARRAHY

MANUFACTURING FIRMS THAT HAVE BEEN FUNDED BY IDBs AND SURVEYED IN RHODE ISLAND 1979 - 1981

1. Shaw Packaging
2. Electronic Precision Co.
3. Avid Airline Products
4. Jay Printing
5. American Hoechst
6. XEY Corporation
7. W. B. Brown
8. Soaring Eagles Ltd.
9. Rubber-Covered Products
10. Stuccato Corp.
11. Rosenthal Technic
12. Paramount Press
13. New England Container
14. Art Mold
15. Dryvit Systems
16. Dome Publishing
17. Microfibres
18. Superior Plastics
19. Blackstone Potato Chips
20. Bevmar Associates
21. JED Ind.
22. Excellent Coffee
23. Foremost Lithographics
24. Trea Industries
25. Cowan Plastics
26. Precision Art
27. Atlan-Tol
28. Bren Corporation
29. Cavanagh & Sons
30. Allied Printing
31. EG & G Sealol
32. Electron Fusion
33. Electro Films
34. Flock-Tex
35. Narragansett Wire
36. Peerless Precision
37. Victory Polishing
38. Taft-Pierce
39. Sunflow Products
40. Universal Optical
41. Uvex Winter
42. Weller (Mari Coultas)
43. Crystal Thermoplastics
44. Cherry Semiconductor
45. Jewel Company of America
46. Amtrol
47. Millard Wire
48. Kienhofer & Mogg, Inc.
49. Norton Company

PROJECTS REJECTED FOR IDB FINANCING IN RHODE ISLAND 1979-1981

During this time period, 22 proposals for IDB financing were rejected.

Two projects -- a K-Mart Shopping Center in Cranston, and the conversion of a Masonic Temple to an office building in Providence were rejected by the Board of Directors of the Rhode Island Port Authority and Economic Development Corporation.

Additionally, twenty projects, the majority of which were retail facilities, were rejected at the staff level.

Mr. **Anthony**. We had a mayor from Norfolk, Va., yesterday, and he indicated he would. I think it would be constructive if we have that.

Governor **Garrahy**. If I may make one final comment, I share your view that we have in my State, I think, and in many Northeastern States, tried to in a conservative way utilize these bonds for job-creation purposes.

We are, I think, sensitive of the criticism that the administration has pointed to and that Members of Congress have looked to as the so-called abuses in the revenue program to eliminate it.

I think our position is that we are a bit concerned about that. In my own State, we have agonized over certain projects for months and months because we know that Congress was looking at these kinds of projects and saying, well, if this State's going to finance that project, maybe that is an abuse.

We have been sensitive about that.

I came to a nearby community here in Washington just a few months ago and was amazed to read on the front page of the newspaper that at an all-night session they approved $700 million in tax-exempt financing because of the fear they would be shut down.

I went back home and said maybe we ought to look at these types of things if some people are at an all-night, one-night session providing 700 million dollars' worth of financing for every conceivable project.

I would be happy to supply you with our list, though.

Mr. **Anthony**. I think what that last comment means, more than anything else, is our legislative agenda sometimes creates a little bit of instability in business planning and it forces you to take a crisis position maybe contrary to what you would like to do.

Governor **Garrahy**. Thank you.

Chairman **Rostenkowski**. Mr. Rangel is recognized.

Mr. **Rangel**. Welcome, Governor. Concerning IDB's, and I unfortunately find myself being very sympathetic to anything that will create jobs and support expansion of business.

But I don't think it should be done this way. I think it is a big ripoff for the investors.

I think the industry makes money without being productive. But in the final analysis with money shortages, it is the only thing that is available.

It seems as though the tax bill is the social recovery package, as well as the economic recovery package, as we cut back in giving assistance, we now give just incentives, hoping that it will create jobs.

What makes you confident that we in the Northeastern area would not suffer more as a result of expanded IDB's by having those businesses that would be inclined to go to the South and Southwest just speed their move up by those States providing IDB financing?

Governor **Garrahy**. I think, Mr. Congressman, in the first place, the history proves that in the Northeast, over 40 percent of the volume of industrial revenue bonding has taken place in the Northeast.

So that the Northeast has made good use, I think, of industrial revenue financing.

The capital formation markets are in the Northeast, and the banking sources to handle these particular procedures are there.

I think it gives ready access to the capital markets in the Northeast, which is favorable to us.

Mr. **Rangel** [presiding]. Thank you.

Any other questions?

If not, thank you, Governor.

My Governor has been most persuasive with your argument.

We have next a panel, National League of Cities, Richard Guthman, chairman, Finance, Administration, and Intergovernmental Relations; Donald Beatty, Municipal Finance Officers Association; Larry F. Clyde, chairman, Public Security Association; Robert Patterson, executive director, Massachusetts Industrial Finance Agency; Grady L. Patterson, State treasurer, State of South Carolina; Thomas White, executive vice president, Council of State Housing Agencies.

Mr. Patterson, Congressman Holland asked me to apologize for his not being here. He wanted to be here, he tried to rearrange his schedule and he thanks you for taking time out as State treasurer to share the thoughts of the people from the sovereign State of South Carolina.

Mr. **Grady Patterson**. Thank you.

Mr. **Rangel**. As you know, the complete written statement will be entered entirely in the record and you may highlight the important parts of your testimony.

You may proceed as you see fit. We will start with Mr. Guthman.

STATEMENT OF RICHARD GUTHMAN, JR., CHAIRMAN, FINANCE, ADMINISTRATION, AND INTERGOVERNMENTAL RELATIONS POLICY COMMITTEE, NATIONAL LEAGUE OF CITIES

Mr. **Guthman**. Thank you, Mr. Rangel.

I want to thank you again on behalf of the National League of Cities' for appearing at one of our panels about a month ago.

It was a pleasure to have you and it was my pleasure to have chaired that panel and to have introduced you. You added much to our conference.

Mr. Chairman, and members of the committee, I am Richard Guthman, council member, Atlanta, Ga., and chairman of the National League of Cities' Finance, Administration, and Intergovernmental Relations Policy Committee.

My primary purpose here today is to urge the committee to pass legislation that will control the issuance of tax-exempt industrial development bonds by State and local governments.

I realize it is highly unusual for local government officials to be asking the Federal Government to do what some would regard as interfering with State and local affairs, but that intervention is necessary if we are going to preserve the municipal bond market for public purposes.

We generally endorse the administration's proposal to control IDB's with some exceptions that I will return to in a moment.

The municipal bond market is ailing, not only because of high interest rates which plague all the markets, but because the spread between tax-exempt and taxable rates has narrowed substantially. Traditionally, the spread between tax-exempt and taxable rates has been about 30 to 35 percent, but in 1981 that margin shrank to 10 to 15 percent; the difference is still dangerously small.

What these shrinking spreads in interest rates tell us is the demand for tax-exempt bonds has fallen relative to other investments.

One reason is that institutional investors have left the market in droves and may not return. Fortunately for us, last year individual buyers attracted by high interest rates replaced some of the demand in the market, or it would have collapsed.

We cannot continue to rely on individuals to prop up this market, though, because the Economic Recovery Tax Act of 1981 not only lessened the need for tax shelter, it also made it more readily available. The changes in tax laws further reduce the demand for bonds.

The bond market functions according to the laws of supply and demand. Interest rates on bonds have increased as demand decreased. Prices on bonds have gone down and supplies have increased. There is little cities or States can do about demand, but we can address the matter of supply.

We need to set priorities on the use of limited tax-exempt credit and, in doing so, we must conclude that public needs such as the building of roads, bridges, sewers, water systems, public buildings, airports, and ports deserve a preference over essentially private purposes.

Therefore, any kind of restrictions that might be imposed on IRB's should not exclude these most important needs.

As it is now, bonds for private purposes are gradually crowding out regular State and local government general obligation and revenue bonds from the market.

As recently as 1976, regular GO and revenue bonds accounted for three-fourths of the long-term, tax-exempt volume. Now they are only half.

Particularly noticeable has been the growth of small-issue IDB's, which have exploded from $1.4 billion in 1976 to an estimated $10.5 billion last year. In that time period, they have gone from 4 percent of the market to 19½ percent of the market. Pollution control bonds and bonds for utilities also represent growing sectors of the market.

To put it aptly, the major question for this decade in public finance is who will get the tax-exempt money, the local hamburger chain or the local highway system?

We endorse the administration's proposals to control IDB's with some exceptions that I have detailed in my formal statement which is being submitted for the record.

We think it is quite ingenious, it forces potential private beneficiaries of bonds to choose the tax break they want instead of receiving a tax break in the form of accelerated depreciation—in other words, ACRS enacted last year—in addition to the tax-exempt financing. The proposal does not eliminate any current authorized uses of bonds.

We are not so naive to think this proposal is not without considerable controversy. There are those who do not want changes whatsoever in the use of IDB's, including many State and local officials.

One of the most controversial aspects of the administration's proposal will doubtless be its application to all IDB's, and not just for small issues.

We support its broad application because, to us, the principle is the same. No matter what the size or purpose of tax-exempt bonds, no taxpayer should have both the benefits of ACRS and tax-exempt financing.

Those that benefit from pollution-control bonds will tell you certainly they serve a public purpose. NLC has been opposed to pollution-control bonds since 1976 because cleanup of air and water from a clearly identifiable source is a responsibility that goes along with being a good corporate citizen.

It is a cost of production that should be borne by the users of the services or goods produced, and not by all taxpayers.

Some bond programs are like old categorical grant programs, we never go back to eliminate them once they have served their purpose.

While I have concentrated my comments so far on IDB's, I do not want to downplay our concern that the minimum tax proposals now under discussion could adversely affect municipal bonds markets.

To us, it would be inconsistent to help the market with the IDB proposal and then, on the other hand, deal it a blow with a minimum tax law. Including interest on tax-exempt bonds or interest deducted on borrowing to purchase or carry tax-exempt bonds, one of the preference items in a minimum tax would lessen the holding of bonds by individuals and for institutional buyers.

Treasury has said banks will be the industry most effected by the minimum tax. But banks, Mr. Chairman, traditionally have been our best customers. We do not wish to quarrel with the idea that every person or business that earns income ought to pay a minimum tax.

However, in the final analysis, while the incidence of a minimum tax may fall on banks or individuals, the economic burden will be on States and local governments.

Thank you very much.

Mr. RANGEL. Thank you.

[The prepared statement follows:]

STATEMENT OF COUNCILMEMBER RICHARD GUTHMAN, JR., ATLANTA, GA., ON BEHALF OF THE NATIONAL LEAGUE OF CITIES

SUMMARY

The National League of Cities urges the committee to pass legislation similar to what the administration has proposed that would limit the issuance of industrial development bonds. NLC also urges the committee not to pass any minimum tax proposal that would adversely affect the municipal bond market.

I. INDUSTRIAL DEVELOPMENT BONDS

A. Controls on IDB's are needed to restore health of municipal bond market and to preseve it for clearly public needs.

1. Interest rates are at record highs.

2. Spread between tax-exempt and taxable rates has been substantially reduced indicating decline in demand for bonds relative to other investments.

3. Changes in tax laws have reduced demand for bonds.

4. An increasing proportion of market is going for bonds that aid private beneficiaries.

B. The administration proposal would limit issuance while preserving the economic development tool of IDB's.

1. NLC supports public hearings, elected-body approval, financial contributions to or for the benefit of the projects assisted, and application of the ACRS trade-off requirement to all IDB's (not just small issues).

2. NLC opposes bond registration and wants to amend the provision relating to small businesses.

3. NLC urges the committee to consider special provisions in the legislation for multi-family housing and solid waste resource recovery projects.

II. MINIMUM TAX

A. Proposals that include interest on tax-exempt bonds or interest deductions on borrowings to purchase bonds as a preference item will result in reduced demand for tax-exempt bonds.

1. Including interest on bonds as a preference item may be unconstitutional because it, in effect, makes bond taxable.

2. Proposals will directly impact on banks, which hold 42 percent of all municipal debt.

3. Incidence of minimum tax will fall on banks, but economic burden will rest with state and local governments.

STATEMENT

Mr. Chairman and members of the committee, I am Richard Guthman, council member in Atlanta, and chairman of the National League of Cities' Finance, Administration, and Intergovernmental Relations Policy Committee. I appreciate your giving me this opportunity, on behalf of NLC, to present the views of city officials on tax matters before the commitee. While NLC has an interest in several tax issues that you will be considering in the coming days, I will confine my remarks to two matters: industrial development bond and minimum tax proposals.

My primary purpose here today is to urge the committee to pass legislation that will control the issuance of tax-exempt industrial development bonds by State and local governments. I realize it is highly unusual for local government officials to be asking the Federal Government to do what some would regard as interfering with state and local affairs, but that intervention is necessary if we are going to preserve the municipal bond market for public purposes. We generally endorse the administration's proposal to control IDB's with some exceptions that I will return to in a moment.

While we are joining hands with the administration in working to pass this initiative, our reasons for doing so are not the same. One of the administration's primary motivations for advancing this proposal is to pick up revenues for the Treasury. Burgeoning Federal deficits are a concern to NLC, too, but it is the current poor health of the bond market, which threatens the availability of capital for basic infrastructure needs of the country, that drives our desire to see IDB's controlled. In addition, we believe that since IDB's are nearly universally available, practically for the asking, they have lost their effectiveness as an economic development tool for cities.

This is a problem we cannot solve ourselves. Any city or state that acts to restrict IDB issuance places itself at a competitive disadvantage with surrounding jurisdictions. Understandably, no one wants to be the first to cut back. To say that it can be handled on a State-by-State basis without Federal legislation ignores reality. Abuses in the use of these bonds and the proliferation of IDB's have been well-known for the last 2 to 3 years; yet in that time no State has acted either to eliminate abuses or to restrict volume. Uniform national controls are needed.

With respect to minimum tax proposals, NLC urges the committee not to pass any proposal that will adversely affect the municipal bond market. Including interest on tax-exempt bonds or interest deductions on borrowings to purchase bonds as a preference item in a minimum tax would reduce the demand for our bonds and further harm an already ailing market.

I. INDUSTRIAL DEVELOPMENT BONDS AND THE CONDITION OF THE MARKET

It will come as no surprise to you to hear that cities have been facing record high interest rates in the municipal bond market this past year. Interest rate records have been occurring in all the markets. What is particularly disturbing, though, is the fact that the spread between tax-exempt and taxable rates has narrowed substantially. Traditionally, the spread between long-term tax-exempt and taxable rates has been about 30 to 35 percent, but in 1981 that margin shrank to 10 to 15 percent. The market has recovered somewhat now, but the spread remains too small.

The significance of that development is that, while all the credit markets are plagued by oppressively high interest rates, the demand for tax-exempt bonds has fallen relative to other investments. One reason for this is that institutional investors are staying away from the market in droves. Fortunately for us, some of that demand has been replaced by individual buyers or else the market would have collapsed last year. The obvious attraction for individuals is the record high interest they can earn—that is good for them but bad for the issuers who have to pay these rates.

Unfortunately for municipal issuers, there are signs that interest rates in the tax-exempt market may stay high relative to taxable rates even if the economy makes a full recovery. Most analysts are predicting that banks, which hold about 42 percent of all municipal debt, will never regain their full appetite for bonds because they have moved to other methods of reducing their tax liabilities.

In addition, the Economic Recovery Tax Act of 1981 not only lessened the need for tax shelter, it made tax shelter more readily available. The act lowered regular tax rates, reduced the top capital gains rate, expanded the use of individual retirement accounts (IRA's), sharply reduced estate taxes, and made other shelters, such as leasing, more attractive. These changes in tax laws further reduce the demand for bonds.

What we see, then, is a market that truly responds to supply and demand forces. Interest rates on bonds have increased as demand has decreased. There is little cities or states can do to adjust demand, but we can address the matter of supply. We need to, in effect, set priorities on the use of limited tax-exempt credit and in doing that we must conclude that clear public needs, such as the building of roads, bridges, sewers, water lines, airports and public buildings, deserve a preference over essentially private purpose needs. We believe that the administration's proposal on IDB's would help to achieve that ordering.

Right now bonds for other than State and local Government uses are being given a de facto preference in the market. Regular State and local government general obligation and revenue bonds account for only about half the total long-term tax-exempt volume; as recently as 1976 they accounted for three-fourths of the volume. Taking their place have been bonds issued for private companies or bonds issued by other than general purpose State and local governments. Particularly noticeable has been the growth of small-issue ID's, which have exploded from $1.4 billion, or 4 percent of the long-term market, in 1976 to an estimated $10.5 billion, or 19.5 percent of the market, in 1981. Pollution control bonds for private industry, which have averaged $2.5 billion since 1976, jumped to $4.3 billion last year. Utilities, which not many years ago issued very few bonds, now account for about 19 percent of total volume.

As you know, most bonds issued for businesses are backed by the creditworthiness of private-sector beneficiaries. Ironically, many beneficiaries of tax-exempt bonds have better credit-standing and easier access to capital than do the State and local government issuers who are lending them their tax exempt privilege or who are competing for capital in the same markeplace. State and local governments are beset by a variety of financial problems brought on by cuts in grant aid, tax and spending lids, slow tax growth, and growing liabilities, all of which affect their ability to service debt. The lending of tax-exemption to private beneficiaries, therefore, effectively allocates credit away from traditional public sector needs. Consequently, cities can't sell, or don't bother to try to sell, bonds for public needs while corporations benefit from cheaper money than could otherwise be obtained in the private markets and 100-percent financing for their projects.

THE ADMINISTRATION PROPOSAL

While we are critical of the growing dominance of IDB's and other private-purpose bonds in the tax-exempt market, we do not think they should be done away with entirely. There is justification for giving tax incentives to encourage urban revitalization, job creation or retention, and the achievement of other public needs outside the Government sphere. That is why we think the administration proposal is particularly ingenious: it forces potential private beneficiaries of bonds to choose the tax break they want, instead of receiving a tax break in the form of accelerated depreciation (i.e., ACRS) in addition to tax-exempt financing. Moreover, it does not eliminate any current statutorially authorized uses of bonds.

Furthermore, NLC believes it is sound public policy to require public hearings on proposed bond-financed projects and approval of bonds by directly elected officials, as called for in the administration proposal. For practical reasons, bond-issuing authorities of nonelected people have been established across the country. They serve important purposes in many cases, but they should not serve to hide the public's business. The granting of tax-exemption is something that should be done only by elected officials acting in the open.

We strongly support the principle embodied in the administration proposal that the issuer must be financially involved in the projects to be assisted. For the last several years NLC has had policy stating that issuers should be associated both "functionally and financially" with the obligations created through IDB's. This involvement assures that the issuer has a stake in the project which, in turn, helps assure that the project meets a public purpose. There are, however, many technical problems with this provision which must be addressed when you write the legislation. Nearly all States have statutory or constitutional prohibitions on "gifts of public funds" to private parties which could cause tremendous difficulty in implementing this requirement. Direct financial contributions of most kinds to a project could be construed to be a "gift of public funds." The requirement must be structured very flexibly so that a contribution can be made "to or for the benefit of" the project assisted. An example would be the provision of improved sewer lines or roads which are not actually part of the project assisted with bonds, but which nevertheless will benefit the project. In addition, the committee might want to consider imposing this contribution requirement only on small-issue IDB's.

As I mentioned earlier, there are parts of the administration proposal to which we take exception. Let me cover those points.

We oppose the requirement that bonds be issued in registered form. The proposal also calls for reporting of all bond sales, which we strongly support and which we think meets the legitimate need of being better able to track all bond activity at the national level. Bond registration will mean higher issuance costs, something NLC has long sought to reduce. This provision goes in the wrong direction.

NLC is also troubled by the provision that would prohibit small-issue IDB's for companies that make capital expenditures of more than $20 million for a 6-year period beginning 3 years before and ending 3 years after the proposed date of issuance. We strongly favor the view that small businesses ought to be helped before large corporations with easier access to capital; however, when IDB's are used for redeveloping an urban area, the feasibility of those projects is usually dependent upon attracting a large, stable company. Once a commitment from a large concern is made to a redevelopment project, other investors typically follow suit. We think this provision will take away what we feel is the primary justification for small-issue IDB's—their use for economic and physical revitalization. We would ask that the provision be amended to make exceptions for such projects.

Along this line, the committee should consider exempting this and the ACRS tradeoff provision in certain economically deteriorated areas. The administration has said it wants to lift the ACRS-tradeoff requirement in urban enterprise zones for small businesses only. We welcome this type of target-area feature, but the administration proposal is inadequate in two respects. For reasons just stated, we think it should not be limited to small businesses. Second, too few enterprise zones will be designated for this approach to have much utility.

Finally, there are two other aspects of this proposal which we want to bring to your attention. It is important to determine the impact of this legislation on bond projects that assist low and moderate income multifamily housing and solid waste resource recovery. With respect to multifamily housing, you will recall that important new incentives for housing production were put in the Economic Recovery Tax Act last year. They would be partially undone by applying the administration's IDB restrictions to multifamily projects, as is proposed. While we are not prepared to offer specific proposals in these areas today, we do want the committee to be aware that these projects that do serve a public purpose could be adversely affected.

AREAS OF CONTROVERSY

We know that passage of legislation to control IDB's will not be easy because of the termendous political opposition that will likely surface to any changes whatsoever. There is not unanimity among city officials on this issue; some, in fact, strongly feel that their right to issue IDB's should in no way be impaired. And, there are, of course, many private parties who directly benefit from IDB's who will oppose it.

One of the most controversial aspects of the administration proposal will doubtless be the application of the ACRS-tradeoff principle to all IDB's and not just to small-issues. We support its broad application because to us the principle is the same no matter what the size or purpose of tax-exempt bonds: no taxpayer should have both the benefits of accelerated depreciation enacted last year and tax-exempt financing.

In my city of Atlanta, for example, we will still be able to issue bonds to build a runway at our airport under the administration proposal. However, if we issue a tax-exempt bond to build a facility for an airline, it is only fair that that airline give up any right to take accelerated depreciation on that part of the facility financed with tax-exempt bonds.

I suspect that nowhere will the cries of protest against this proposal be louder than from those who benefit from pollution control bonds. NLC supports their inclusion in this proposal. In fact, we have had a policy since 1976 that pollution control bonds which support private facilities or improvements that bear no relationship to traditional municipal services or functions should be abolished.

Cleaning up air or water pollution from a clearly identifiable source is a responsibility that goes along with being a good corporate citizen. The cost of that clean-up should be borne by the users of the goods or services produced and not by all taxpayers.

When pollution control bonds were authorized in 1968, they were seen as an incentive for private industry to improve the environment. Later, they were viewed as partial compensation for Federal environmental mandates imposed on industry. It was thought that the bonds would be used for retrofitting plant and facilities, investments which might not be recoverable in prices charged for goods or services.

But, the job of retrofitting should be done by now. Pollution bonds being issued now are generally for new plant and equipment. These costs should be seen a costs of production and not something that should be subsidized by the Federal Government through loss of tax revenues or by state and local governments through loss of capital and increased interest costs on bonds.

Some bond programs are like categorical grant programs. We never go back to eliminate them once they have served their intended purpose.

Again, I would emphasize that all the administration proposal would require is that a company that wants to use a tax-exempt bond give up a tax benefit that wasn't available to it just a year ago. Those that argue that they shouldn't have to do that are, in effect, admitting that they do not want to forego ACRS, which must mean that it is a very attractive tax break for them.

II. THE MINIMUM TAX

At this point, I want to turn to the matter of the minimum tax proposals. For the same reasons I have just given about the need to strengthen and protect the municipal bond market so that public needs can be met, NLC must oppose any aspect of a minimum tax that could adversely affect the market. Unfortunately, we believe that those proposals currently under discussion will have those adverse effects.

Under the administration's proposal for a minimum corporate tax, one of the items to be added back in determining a company's reconstructed tax base, if it is subject to the minimum tax, is interest deducted on borrowings to purchase or carry tax-exempt securities. The Treasury Department has stated that the industry most affected by a minimum corporate tax is banking, and it is primarily because of this provision relating to borrowings to purchase bonds.

The Chairman of the Senate Finance Committee favors a proposal that would take the administration's proposal two steps further by extending the tax to individuals and by including interest earned on tax-exempt bonds as one of the preference items to be added back in determining the tax. In our estimation, that proposal would have an even more serious effect on the market. In addition, it could possibly be unconstitutional because it, in effect, makes tax-exempt bonds taxable.

If either of these proposals is enacted, the likely effect will be that banks will not buy as many municipal bonds and/or they will adjust their portfolios by selling off bonds. Keep in mind that banks have long been our best customers, buying about 42 percent of all bonds issued. We are already worried that banks will not be buying as many bonds in the future. A minimum tax imposed on them will only exacerbate the problem.

We do not wish to quarrel with the idea that every person or company that earns income ought to pay some minimum tax. However, we want to point out that while the effective Federal tax rates banks pay may generally be low, that fact masks the service they provide to States and local government in buying our bonds. In the final analysis, while the tax burden imposed by a minimum tax that includes either interest on borrowings to buy bonds or interest earned on bonds may fall on banks or individuals, the economic burden will ultimately rest with States and local governments.

Mr. RANGEL. Donald Beatty, Municipal Finance Officers Association.

STATEMENT OF DONALD W. BEATTY, EXECUTIVE DIRECTOR, MUNICIPAL FINANCE OFFICERS ASSOCIATION

Mr. BEATTY. Mr. Chairman, we appreciate the opportunity to appear before the committee to explain the severe consequences that the 1981 tax and budget actions have had on State and local government finance.

We must also report to you that the value of tax exemption is being severely eroded and, as a consequence, the borrowing costs for State and local governments are increasing faster than the general rise in interest rates.

With this as background, we have no choice but to strongly oppose the inclusion in any minimum income tax of a preference item which would, directly or indirectly, affect the tax-exempt bond market.

Taken all together, the combination of significant cutbacks in Federal grant-in-aid funds to State and local government, the unintended effects of the Federal tax law enacted last year, and the monetary policies of the Federal Reserve Board have represented a triple whammy for State and local government finances.

First, the budget actions have brought on severe reductions in grant-in-aid receipts for State and local governments. Second, in the municipal bond area there have been some adverse, unintended impacts resulting from the 1981 tax revisions. Third, crowded and uncertain capital market conditions accompanying continued Federal deficits and tight monetary policies have forced our governments to radically alter their plans for the capital construction necessary to maintain the infrastructure in our States, cities and counties.

Tax-exempt interest rates have spiraled to over 13 percent—Bond Buyer 20-Bond Index—and the traditional gap between taxable and tax-exempt rates is closing rapidly. Thus, as a consequence, tax exemption, as a means of decreasing the borrowing costs of State and local governments, is slowly losing much of its value.

Changes enacted in the Economic Recovery Tax Act of 1981 will cause systematically higher interest rates for municipal bonds compared to those on taxable securities. Looking first at those provisions of the Tax Act that affect individual taxpayers, several will have an adverse impact on tax-exempt interest rates:

The reduction in personal income tax marginal rates, especially the lowering of the top bracket from 70 percent, on unearned income, to 50 percent for all income.

The associated reduction in the capital gains rate, which will drop from a maximum of 28 percent to 20 percent, thereby improving the attractiveness of equity holding in relationship to fixed-income securities.

Expansion of income-sheltering opportunities in individual retirement savings plans—IRA and Keogh.

Partial exemption of interest income and indexation of marginal tax brackets, commencing in 1985.

The creation of the all-savers certificate which has resulted in a superior tax-exempt, short-term instrument that is federally guaranteed.

They have all had adverse impacts on municipal bonds.

Leasing tax shelters, the investment tax credit, the accelerated depreciation are all reducing commercial bank demands for municipal securities.

On the other side of the ledger, there will be an increased pressure on our governments to borrow funds because of the cutbacks in Federal grant-in-aid, both enacted and proposed, new responsibilities which our governments may have to assume in an era of New Federalism.

We do not find it to be within our province to advise this committee concerning the desirability of adopting a new minimum income tax on corporations. We must comment on one of the 14 preference items recommended by the administration which we feel would have a significant impact on the tax-exempt bond market.

As is detailed in our written statement, we feel that the inclusion of the preference item on the interest deductions for debt to carry tax-exempt securities would radically alter commercial bank purchases of both long-term, tax-exempt bonds and short-term, tax-exempt securities.

We do not oppose this preference item on behalf of the financial institutions involved but, rather, on behalf of State and local governments and our taxpayers who end up financing the cost of this tax through higher interest payments on tax-exempt securities. Given commercial banks' current holdings of approximately $155 billion in tax-exempt securities, our calculations indicate that banks would reduce their holdings of municipal bonds on an order of 25 to 30 percent.

Tax-exempt interest costs are estimated to increase from $960 million to $1.6 billion, just in the first year following the change in the tax law. We do not foresee all these changes occurring at once, but the effect on tax-exempt interest rates would still be significant.

Our current estimate which we feel is conservative, is that tax-exempt interest costs would increase on the order of $1.3 billion.

One of the many pressures described in our written testimony that is causing a significant problem in the tax-exempt bond market is the use of tax-exempt bonds for private purposes.

We believe that small-issue industrial revenue bonds are open for congressional consideration, especially in light of the large volume increase in this area and the uncontrolled use of these bonds.

The Municipal Finance Officers Association opposes the use of tax-exempt, small-issue industrial revenue bonds unless they are used in areas of serious economic deprivation. We believe the cornerstone of the administration's proposals denying the use of accelerated depreciation to beneficiaries of industrial revenue bonds ought to be applied to the small-issue bonds.

Furthermore, we believe that small-issue industrial revenue bonds should be targeted and used as an economic development tool if this restriction were not applied in areas suffering serious economic deprivation.

Thank you very much, Mr. Chairman.

Mr. RANGEL. Thank you, Mr. Beatty.

[The prepared statement follows:]

STATEMENT OF DONALD W. BEATTY, EXECUTIVE DIRECTOR, MUNICIPAL FINANCE OFFICERS ASSOCIATION

Mr. Chairman, we appreciate this opportunity to appear before the House Ways and Means Committee to explain the severe consequences that the 1981 tax and budget actions have had on state and local government finance. We must also report to you that the value of tax exemption is being severely eroded and, as a consequence, the borrowing costs for state and local governments are increasing faster than the general rise in interest rates. While state and local governments share the difficulty of high interest rates that are a burden on all sectors of our economy, we have come in for some special problems in the last year. An additional factor which is affecting tax-exempt interest rates is a large-volume of private-purpose, tax-exempt borrowing. It is for this reason that we encourage the U.S. Congress to pass legislation this year which will restrict small-issue industrial revenue bonds. With this as background, we have no choice but to strongly oppose the inclusion in any minimum income tax a preference item which would, directly or indirectly, affect the tax-exempt bond market.

I. Municipal Bond Market

Taken all together, the combination of significant cutbacks in Federal grant-in-aid funds to state and local government, the unintended effects of the Federal tax law enacted last year, and the monetary policies of the Federal Reserve Board have represented a triple whammy for state and local government finances. First, the budget actions have brought on severe reductions in grant-in-aid receipts for state and local governments. Second, in the municipal bond area there have been some adverse, unintended impacts resulting from the 1981 tax revisions. Third, crowded and uncertain capital market conditions

---

* The Municipal Finance Officers Association represents 9,000 members who are state and local government finance officials, appointed or elected, and public finance specialists. MFOA is headquartered in Chicago, Illinois, and also maintains a Washington, D.C., office.

accompanying continued Federal deficits and tight monetary policies have forced our governments to radically alter their plans for the capital construction necessary to maintain the infrastructure in our states, cities, and counties.

Tax-exempt interest rates have spiraled to over 13 percent (Bond Buyer 20-Bond Index) and the traditional gap between taxable and tax-exempt rates is closing rapidly. Thus, as a consequence, tax exemption, as a means of decreasing the borrowing costs of state and local governments, is slowly losing much of its value.

Changes enacted in the Economic Recovery Tax Act of 1981 will cause systematically higher interest rates of interest for municipal bonds compared to those on taxable securities. Looking first at those provisions in the Tax Act that affect individual taxpayers, several will have an adverse impact on tax-exempt interest rates:

- The reduction in personal income tax marginal rates, especially the lowering of the top bracket from 70 percent (on unearned income) to 50 percent for all income.
- The associated reduction in the capital gains rate, which will drop from a maximum of 28 percent to 20 percent, thereby improving the attractiveness of equity holding in relationship to fixed-income securities.
- Expansion of income-sheltering opportunities in individual retirement savings plans (IRA and Keogh).
- Partial exemption of interest income and indexation of marginal tax brackets, commencing in 1985.
- The creation of the All Savers Certificate which has resulted in a superior tax-exempt, short-term instrument that is federally guaranteed.

Looking at corporate purchases of municipal bonds, the following provisions in the new tax law will have adverse impacts: expansion of leasing tax shelters, an increase in the investment tax credit, and accelerated depreciation schedules which, along with the ITC, will both enhance the rate of return on alternative investments and lessen the need for tax shelter from municipal securities. Expansion of these opportunities may prove to be especially significant in further reducing commercial bank demand for municipal securities.

Looking at the demand for municipal bonds, there were several negative trends which also started last year. Demand for tax-exempt bonds by institutional investors, namely commercial banks and casualty insurance companies, practically evaporated. Correspondingly, individuals (including mutual funds) acquired two-thirds of all state and local debt last year. Commercial banks and fire casualty insurance companies — which in the late 1970s acquired 80 to 90 percent of net increases in municipal bonds — have shown only minimal interest over the past few years. This pattern of demand illustrates the critical importance of the individual investor to the municipal securities market, and the higher yields which are necessary to attract these individuals to purchase municipal bonds.

On the other side of the ledger, there will be increased pressure on our governments to borrow funds, because of the cutbacks in Federal grant-in-aid approved last year and those proposed in the current Federal budget. For example, Federal grants over the last decade have financed approximately 37 percent of all state and local construction spending. Sharp reductions in those grants will require increased borrowing if the projects are to go forward. The tax-exempt bond market simply cannot accommodate this increased public purpose borrowing with the high level of private purpose borrowing that is projected in the next five years.

For the above reasons, the long-term prognosis for the tax-exempt bond market is not good. This is not to say that tax-exempt interest rates will not drop when other rates drop, but rather, in relationship to taxable rates, they will remain at much higher levels than we have seen traditionally.

II. The Effect of the Administration's Minimum Income Tax on State and Local Governments

We do not find it to be within our province to advise this Committee concerning the desirability of adopting a new minimum tax on corporations. But, we must comment on one of the 14 preference items recommended by the Administration which we believe would have a significant effect on the tax-exempt bond market.[1] We do not oppose this preference item on behalf of the financial institutions involved but, rather, on behalf of state and local governments and our taxpayers who would end up financing at the state and local level the cost of this Federal tax through higher interest payments on tax-exempt securities.

Inclusion of a pro-rated share of interest costs in the minimum income tax base would fundamentally change the demand of commercial banks for tax-exempt securities, further lessening the advantage to banks in owning those securities and, thereby, driving up interest rates. Interest rates on tax-exempt securities are already at an all-time high. The Economic Recovery Tax Act and the Budget Act of last year struck devastating blows, both directly and indirectly, at state and local finances and the municipal securities market. We do not think that state and local governments, nor the municipal bond market, should have to sustain yet another devastating blow in the formulation of Federal tax policy.

---

[1] Preference item Number 9 in the Administration proposal states, "(9) deductions for debt to buy or carry tax-exempt securities."

Nonetheless, by enacting this measure, the Congress would be greatly lessening the desirability of municipal security holdings for our largest investor, commercial banks. Commercial banks continue to be the mainstay of the municipal bond market. Altogether, these financial institutions at present hold approximately 45 percent of outstanding municipal securities. Furthermore, bank ownership is especially crucial in the shorter maturities, which is the rapidly growing area of the market given the lack of credit and its high cost in the longer maturities.2/

As has been frequently cited, bank demand is crucial to the health of the municipal bond market. In view of the fact that commercial banks hold such a large proportion in municipal securities, any action that greatly weakens their demand will have severe adverse impacts on that market. Bank demand can change rapidly. As of September 1981, commercial banks held an estimated $20 billion in short-term, tax-exempt securities (those due in less than one year) and probably another $10 - 15 billion in bonds maturing within a year. Thus, banks have the capacity to alter their portfolios rapidly to reflect the changing advantage of different security holdings. While this represents a source of overall liquidity to banking institutions, it also poses a threat of an immediate drying-up of bank demand for new securities, as older securities are allowed to mature without replacement.

Right now, the pressure on the municipal bond market is particularly severe. Banks have not been increasing their holdings of municipal securities at a pace which would provide ready access to the market. On the other hand, banks have been maintaining their existing holdings of tax exempts, largely replacing maturing bonds and notes with new purchases. With the imposition of a minimum

---

2/ We estimate that banks hold $20 billion of the approximately $25 to $30 billion in short-term, tax-exempt debt outstanding.

tax on the interest on borrowing arbitrarily allocated to tax-exempt security holdings, it is our belief that bank demand for municipals would decline drastically.

A recently completed MFOA analysis entitled "An Analysis of the Impact of the Proposed Corporate Minimum Income Tax on Tax-Exempt Interest Rates and Borrowing Costs" provides reasonable estimates as to the impact of that decline on tax-exempt interest rates. Our current estimate is that the inclusion of interest on debt used to purchase and carry tax-exempt bonds in the minimum tax would decrease commercial bank desired holdings of municipal securities on the order of 25 to 30 percent. The minimum tax would move banks from the current situation of slowly acquiring municipal securities, to finding themselves with a large surplus of these securities. This change in desired holdings would have disastrous implications for interest rates in the tax-exempt market.

A major reason for these adverse outcomes is that, aside from the commercial banks, the other major institutional investor in tax-exempt bonds is the property and casualty (non-life) insurance companies. At present, their demand for tax-exempt securities is depressed with little prospect for immediate recovery. Once the two major institutional investors (banks and casualty insurance companies) are removed, there remains only the household sector, which is fundamentally made up of individual investors. Sales of municipal securities to these investors are expensive because high yields are required to attract and retain individuals who find their income tax burdens steadily declining and, thus, tax exemption is of less savings to them. Also, the average size of transaction is smaller and more costly than those involving institutions.

Using one line of analysis in the study, we have found that as a result of the minimum tax bank demand for tax-exempt securities would be lowered on the order of 25 to 30 percent of their current holdings of tax-exempt securities. Given the banks' current holdings of $155 billion tax-exempt securities, our calculations indicate that banks, in following profit-maximizing behavior, would want to hold only approximately $112 billion, were the minimum income tax in effect with regard to the taxation of interest cost deductions.

The discrepancy of $43 billion between the present and desired bank holdings of tax-exempt securities is the focal point of calculating the interest rate impacts and the reduced availability of credit to state and local issuers. In view of the fact that banks currently hold $20 billion in tax-exempt notes and, perhaps, another $15 billion in longer-term securities maturing within one year, the downward adjustment in bank holdings might take place very rapidly. Banks might simply stop buying new tax-exempt securities and, as a result, what has been traditionally one-half of the market demand for our obligations would disappear overnight and for one year's duration. We doubt that would happen, but a substantial and continuing depression in bank demand, as they reduced municipal holdings in their portfolios, would be a certainty.

Prior analysis has estimated that $1 billion in added supply increases tax-exempt bond rates by 3 to 5 basis points. Using those estimates, a $40 billion surplus in bank holdings would generate an 120 to 200 basis point upward pressure on tax-exempt yields, given the level of taxable interest rates.

As Table 1 indicates, as of early 1982, the tax-exempt bond rates have been approximately 13 percent. Municipal bond yields have averaged approximately 80 percent of the yield on comparable taxable securities (which recently have been around 16 percent). An added 120 to 200 basis points would mean tax-exempt rates of 14 to 15 percent — very high, but by no means unheard of in the tax-exempt market these days. Correspondingly and more significantly,

---

NOTE: A basis point equals one one-hundredth (1/100) of a percent.

the ratio of tax-exempt to taxable yields could climb to 85 or 90 percent, were taxable yields not to change in value. At such high ratios, tax-exempt securities would lose practically all value to governments as a means of lowering borrowing costs.

We do not foresee that dire result occurring all at once, but the direction of the pressure is clearly evident. If we estimate the true impact to be roughly the mid-point of the possible impact, the market would experience a 160 basis-point increase in tax-exempt rates, on average. At an $80 billion annual level of municipal bonds ($50 billion long term and $30 billion short term) this works out to an added $1.3 billion a year in tax-exempt borrowing costs, looking only at the first-year costs. Since the long-term bonds will be outstanding for many years (say, 10 years on average), the total added cost of borrowing would be much greater during the period the bond was outstanding.

According to the information released by the Treasury Department on February 26, 1982, the minimum income tax proposal would be expected to produce additional federal revenue of $4.8 billion in 1984. This, added to the current minimum income tax collections, would produce a total of $5.3 billion in that same year. The Treasury Department estimates that 2.9 percent of their minimum income tax will be collected from banking institutions, or approximately $153 million in 1984, as opposed to their present collections of $9 million.

Even if we assumed that most of this revenue would flow from taxing the interest deduction preference item, it appears that the federal government would pick-up a very small amount of revenue ($144 million) compared to the costs which would be imposed on tax-exempt borrowers ($1.3 billion).

Our opposition to this preference item is based on equity and economic hardship — the Administration has proposed turning over responsibilities to us, but this proposal from the Administration would make it very difficult for us to finance these new government programs at the state and local levels of government.

III. Industrial Revenue Bonds

The Municipal Finance Officers Association has testified before Congress on a number of occasions in opposition to the use of tax-exempt bonds that only benefit private industries and are not functions of state and local government. To be specific, in 1968, we adopted a policy which has formed the framework of our concerns in this area. This policy states that bonds which, regardless of purpose, are, in practical effect, the obligations of private industries with state and local governments acting only as conduits for private borrowing should not be continued in the tax-exempt bond market.[3] In 1975, we indicated to Congress our opposition to pollution control bonds and in 1978, we opposed the expansion of the small-issue limit, because at that time we predicted that increasing the limit from $5 million to $10 million would lead to an unwarranted proliferation of small-issue industrial revenue bonds.

At this time, we feel Congress should devote attention to adopting restriction on small-issue industrial revenue bonds. Our Association has two principal concerns about the present use of small-issue IRBs. First, small-issue IRBs are occupying an increasing share of the tax-exempt bond market. The 1981 level is estimated at approximately $10.5 billion, or 20 percent of the market. Second, the universal availability of small-issue IRBs in practically every state and community does not give any area an advantage in an economic development sense and may, in fact, promote the flight of downtown businesses away from our urban areas.

The MFOA has carefully studied the market for tax-exempt bonds and through this research, we have expressed legitimate concerns about its capacity to absorb, without cost, so-called conduit bonds. Small-issue IRBs must be examined along with all other conduit IRBs in order to fully understand their cumulative effect on the municipal bond market.

---

[3] "Conduit bonds" refer to industrial development bonds for which the issuing local government has no financial involvement with its own resources and also has no functional involvement in that the facility financed is one which it could not itself operate as its own public facility.

Of major concern to state and local governments is the extent to which small-issue and other IRBs are crowding out the market for conventional state and local debt issues, absorbing capital that would normally go to the financing of traditional governmental activity and driving up the costs of borrowing for all tax-exempt issuers. Research over the years has documented that the laws of supply and demand hold true in the tax-exempt market: the greater the demand for funds in relationship to the supply of savings at any given time, the higher will be the interest rates in the tax-exempt market.

Quantifying the impacts of increased supply of tax-exempt securities on the availability and cost of credit is difficult. Research findings indicate that the rapid growth and large volumes of credit demands do exert upward pressure on rates of interest and difficulties for traditional governmental borrowers that must compete for credit with new claimants. At current market levels, it is estimated that an increase of $1 billion in tax-exempt securities can be expected to generate interest rates that are 3 to 5 basis points higher for the overall market than otherwise would be the case.4/ For smaller debt issues that depend on support from local markets (and where there may be a high degree of substitution by investors between the traditional debt and that being sold for nontraditional purposes) the impact of increased volume on interest rates and credit availability can be much greater. For example, small issuers in states where there is a large amount of IRB financing would see their borrowing costs going up by a

---

4/ For a review of recent studies regarding the interest rate effects of incremental supplies of tax-exempt bonds, see Ronald Forbes, et. al., "An Analysis of Tax-Exempt Mortgage Revenue Bonds," Municipal Study Group, State University of New York at Albany (May 1979) Appendix III.

larger factor than would be true elsewhere in the market as a whole because of competition for local investment funds.[5]

The Treasury estimate of $10.5 billion in sales in 1981 of small-issue IRBs would imply that state and local borrowing costs, as reflected in rates of interest, were 31 to 52 basis points higher that year than they otherwise would have been. At an annual level of $50 billion in municipal bond sales, this implies increased annual borrowing costs of $155 to $260 million annually for each year that bonds sold in a given year remain outstanding. Thus, were the municipal securities to be outstanding for an average of 12 years, the total added costs in increased interest over the life of the debt would range between $1.9 billion and $3.1 billion.[6]

It should be pointed out that these numbers relate only to the 1981 sales figures for IRBs. If, in fact, the volume of IRB new issues rises as forecasted by the Congressional Budget Office, the increased borrowing costs would rapidly cumulate for all state and local borrowers.

Commercial bank purchases of industrial revenue bonds is not a healthy sign, in the long term, for the traditional municipal bond market. The CBO study estimates that 70 to 80 percent of small-issue sales are private placements.[7] Since most small-issue IRBs are privately placed with banks, there are limited opportunities for the banks to sell these tax-exempt securities. Banks may be filling their portfolios with tax-exempt IRBs and, therefore, lessening their ability to purchase tax-exempt bonds for schools, sewers, and street projects. With commercial banks maintaining their role as the single-largest holders of tax-exempt bonds,[8] any shift in their demand for general obligation (or tax-supported) bonds for governmental purposes is a disturbing sign for state and local governments. If tax-exempt IRBs continue to play a major role in providing capital financing for business and industry, then the traditional municipal bond market is headed for troubled waters.

---

[5] For an analysis of the local market impacts of increased offerings, see Hendershott, Patric and David Kidwell. "The Impact of Relative Security Supplies: A Test with Data from a Regional Tax-Exempt Bond Market." Journal of Money, Credit and Banking. February 1978.

[6] The present value of $1.9 billion and $3.1 billion, assuming an annual inflation rate of 10 percent over the 12 years, is $600 million and $990 million.

[7] CBO, Small Issue Industrial Revenue Bonds, p. 15.

The Use of Small-Issue Industrial Revenue Bonds as an Economic Development Tool

Many witnesses will submit testimony to this Committee indicating that small-issue industrial revenue bonds are an important economic development tool. They will tell you of the many jobs created through their use and of the firms that would not be able to build new facilities or expand existing facilities without this subsidy. The evidence simply does not support these claims. The universal availability of small-issue IRBs does not currently provide any individual community with a competitive advantage. One of the recent studies on this subject, by Margaret E. Dewer[9] examined how effective IRBs are in influencing a corporation's location and expansion decision. According to Dewar:

> . . . the importance of the interest rate subsidy and other advantages of using the bonds is not likely to outweigh the importance of location criteria such as the cost of shipping products or the cost of acquiring suitable land. If other location characteristics dominate the decisions, the bonds probably have virtually no effect on location and expansion choices. In that case, the major result of bond programs is to reward firms for behaving as they would without the programs.[10]

---

[8] See Federal Reserve Board, Flow of Funds Accounts.

[9] Dewar, Margaret E., The Usefulness of Industrial Revenue Bond Programs for State Economic Development: Some Evidence from Massachusetts, Working Paper No. 63, Joint Center for Urban Studies of the Massachusetts Institute of Technology and Harvard University, March 1980.

[10] Ibid, pp. 1-2.

The Municipal Finance Officers Association believes that small-issue IRBs could be used as an effective economic development tool if they are restricted to areas of serious economic deprivation. Instead of providing a subsidy so that firms can flee our downtown areas, we ought to be encouraging economic development in areas of serious economic deprivation. If the Congress agrees with the Administration's recommendation to prohibit the use of the accelerated cost recovery system of depreciation in combination with IRBs, we encourage Congress to lift that restriction when the small-issue IRBs are used in areas of serious economic deprivation.

The Need for Federal Legislation

The MFOA adopted, at its last Annual Meeting, a policy supporting Federal restrictions in small-issue IRB area. Our Association came to the conclusion that this is an area in need of restrictions at the Federal level of government. Many of the state and local officials who are members of our Association have tried to restrict small-issue IRBs at the state and local level of government but have come to the conclusion that it is extremely difficult, if not impossible, for any state or, for that matter, local government to ban or severely restrict IRBs when neighboring communities and states continue to offer them. State legislatures which have attempted to pass IRB restrictions have not been able to overcome this argument. It is our belief that the current small-issue IRB climate leads to negative and unhealthy competition among the states and unless Federal restrictions are adopted, the use of small-issue IRBs will continue unabated.

Comments on the Administration's Proposal

We applaud the Administration for proposing restrictions on industrial revenue bonds to the U.S. Congress. While we do not fully support all of the recommendations contained in the Administration's IRB proposals, we find their support of restrictions encouraging.

The cornerstone of the Administration's bill proposing a trade-off between the use of tax-exempt bonds or ACRS depreciation should be supported by Congress. As indicated above, we would like to see this restriction lifted for small-issue IRBs in areas suffering serious economic deprivation.

The most serious problem with the Administration's proposal is the requirement that the state or local government make a financial contribution to a project which might be financing a private corporate activity. Most state constitutions deny state or local governments the power to donate or lend money or credit to private individuals. The practice of state governments borrowing for the benefit of private enterprise reached its peak in the 1850s when states competed in efforts to attract railroads. Subsequent large-scale bond defaults during the Depression of 1870 caused strong public reaction to the lending of state credit to individuals or corporations. Many states adopted constitutional amendments to prevent a reoccurrence of such practices. Based on experience, we believe that it would be difficult, if not impossible, for the states with such restrictions to amend their constitutions or laws prior to December 31, 1985. Such a restriction would, therefore, make industrial revenue bonds unworkable in most of the states.

We agree that it is important to secure the approval of the elected officials in the local government for industrial revenue bond projects. This approval can be achieved by requiring a public hearing on the projects and also by requiring approval of the projects by the elected legislative body of the governmental unit. This hearing and approval process will bring the IRB projects to the public view and will also hold local government officials accountable for the use of tax-exempt credit for the projects.

The Administration has also proposed restrictions in the area of arbitrage. When Congress adopted the 1968 legislation concerning industrial revenue bonds, it listed in the Code purposes which were allowable for industrial revenue bonds. Some of those items are only for private industries while others, such as municipal parking facilities, mass transportation, and airports, can be for governmental activities. We do not object to the placing of restrictions on industrial revenue bonds which are strictly conduit bonds. We do think, however, that the Administration's arbitrage proposal would be too far reaching and might affect governmental projects and, therefore, it needs to be carefully examined and then redrafted by Congress.

The Administration has also suggested that information on each industrial revenue bond be reported to the Internal Revenue Service. We think that the paperwork and administrative requirements generated by this requirement would be too cumbersome. Instead, we suggest that each state be required to gather information on industrial revenue bond sales and, in turn, report that information to an independent Federal body such as the Advisory Commission on Intergovernmental Relations or similar entity.

Conclusion

The question before us today is: Will the tax-exempt market continue to be available to finance the facilities of state and local governments in an economical way? Will general obligation bonds and those supported by other tax revenues be able to sell in the future? To those who point to the jobs and economic benefits of industrial revenue bonds we must ask this: If we cannot finance our streets, highways, bridges, water and sewer facilities, ports, and transit facilities with tax-exempt bonds, will we have the necessary infrastructure in place to support the activities of the industrial enterprises which they would like to see financed with tax-exempt bonds? If we decide that tax-exempt bonds are needed to finance state and local government facilities, then the uncontrolled issuance of industrial revenue bonds must be stopped.

TABLE 1

BOND BUYER 20 BOND INDEX (TAX-EXEMPT),
MOODYS ALL-INDUSTRY CORPORATE BONDS (TAXABLE),
AND RATIO OF RATES:
1978 to 1982.I

Year/Quarter	Bond Buyer 20 Bond Index (Tax-Exempt)	Moody's All-Industry Corporate Bonds (Taxable)	Ratio Of Tax-Exempt To Taxable (%)
1978 (yr.)	6.07 %	9.07 %	66.9 %
1979 (yr.)	6.53	10.12	64.5
1980/I	8.56	12.80	66.9
1980/II	7.86	12.32	63.8
1980/III	8.79	12.30	71.5
1980/IV	9.61	13.67	70.3
1981/I	9.97	14.09	70.8
1981/II	10.68	14.89	71.7
1981/III	12.03	15.65	76.9
1981/IV	12.59	15.64	80.5
1982/I*	13.13	16.09	81.6

---

* First two months data

AN ANALYSIS OF THE IMPACT OF THE PROPOSED CORPORATE MINIMUM INCOME TAX ON TAX-EXEMPT INTEREST RATES AND BORROWING COSTS

John E. Petersen
Government Finance Research Center
Municipal Finance Officers Association
March 1982

Under the recent Treasury proposals, a new section will be added to the current minimum tax provisions, imposing a new 15 percent alternative tax on corporate minimum taxable income in excess of $50,000.[1] The tax base will be a corporation's regular taxable income, increased by the sum of certain special deductions.

One revision in the corporate minimum tax base (Item #9) would be inclusion of interest on indebtedness used to purchase or carry tax-exempt securities (to the extent such interest is deducted under current law). The current rule of section 265(2) disallowing deduction of expenses and interest relating to tax-exempt income does not apply to commercial banks (or to other financial institutions having less than 15 percent of their total assets invested in the tax-exempt obligations). In determining the amount of interest deduction to be added to the minimum tax base, the corporation's total interest deductions would be allocated pro rata across its total investment portfolio. Thus, in effect, that share of interest cost now deductible against income taxes would be subject to the minimum tax of 15 percent. Because of their major holdings of tax-exempt securities and their low taxable profits on economic income because of the nonapplicability of section 265(2), commercial banks are the key target of the new minimum tax provision.

Impact on Bank Demand for Municipal Securities

The proposed change would greatly reduce the attractiveness of tax-exempt securities to commercial banks. Bank demand is crucial to the health of the municipal bond market. Because commercial banks, as the largest single investor group in such securities, hold about $155 billion, or 45 percent, of all outstanding municipal securities, any action that greatly weakens their demand for these credits will have severe adverse impacts on the tax-exempt securities market. Furthermore, bank demand can change rapidly. As of September 1981, commercial banks held an estimated $20 billion in short-term, tax-exempt securities (those due in less than one year), and probably another $10 to 15 billion in bonds maturing within a year. Thus, banks have the capacity to alter their portfolios rapidly to reflect the changing advantageousness of different security holdings.

---

[1] See: Department of the Treasury, General and Technical Explanations of Tax Revisions and Improved Collection and Enforcement Proposals, February 26, 1982.

At present, the pressure on the municipal bond market, relative to other credit markets, is particularly severe. As Table 1 depicts, the ratio of tax-exempt to taxable rates has risen sharply over the past year. Interest rates are high in all the securities markets, but nowhere has the increase been so abrupt and unrelenting. The practical consequence of this is that tax exemption has lost much of its cost-saving advantage to state and local government issuers. Major reasons for these poor conditions in the tax-exempt market are the impacts of recent tax code changes, recessionary conditions that have reduced profits and income, and credit concerns surrounding state and local issuers. Any step that further handicaps the tax-exempt securities market and raises borrowing costs must be viewed with concern.

A corporate minimum income tax that includes the pro-rata share of interest deductions on the presumption that the interest is used to carry tax-exempt securities would reduce the demand for tax-exempt securities by commercial banks. To measure the impact of this outcome on the tax-exempt market and the cost of borrowing to issuers requires answering three subquestions:

1. By how much will commercial bank demand for tax-exempt securities be reduced?

TABLE 1

BOND BUYER 20 BOND INDEX (TAX-EXEMPT), MOODYS ALL-INDUSTRY CORPORATE BONDS (TAXABLE), AND RATIO OF RATES:

1978 to 1982.I

Year/Quarter	Bond Buyer 20 Bond Index (Tax-Exempt)	Moody's All-Industry Corporate Bonds (Taxable)	Ratio Of Tax-Exempt To Taxable (%)
1978 (yr.)	6.07 %	9.07 %	66.9 %
1979 (yr.)	6.53	10.12	64.5
1980/I	8.56	12.80	66.9
1980/II	7.86	12.32	63.8
1980/III	8.79	12.30	71.5
1980/IV	9.61	13.67	70.3
1981/I	9.97	14.09	70.8
1981/II	10.68	14.89	71.7
1981/III	12.03	15.65	76.9
1981/IV	12.59	15.64	80.5
1982/I*	13.13	16.09	81.6

---

* First two months data

2. What will be the impact of reduced bank demand on interest rates in the tax-exempt securities market?

3. How will the total cost of borrowing to states and localities change in response to the rise in tax-exempt interest rates?

Reduction in Commercial Bank Demand Caused by Minimum Tax

As is discussed in a separate appendix to this paper, it can be shown that under certain simplifying assumptions regarding profit-maximizing behavior, the optimum proportion of tax-exempt assets (those with tax-exempt income) to total assets can be estimated by the ratio of the average cost of interest and operations per dollar of assets to the average rate of return on taxable investments. If banks are maximizing their after-tax return, their portfolios should approximate the following composition of tax-exempt to total assets:

$$(E/A)^* = \frac{\text{Tax-Exempt Assets}}{\text{Total Assets}} = 1 - (r_c/r_t)$$

where,

r_c = average rate of total cost (interest and operating costs),

r_t = average rate of taxable return on assets,

$(E/A)^*$ = optimal proportion of tax-exempt assets to total assets.

Under the proposed change in the corporate minimum tax law, it can be deduced that the optimum ratio of tax-exempt to total assets would be determined by the expression:

$$(E/A)^{**} = \frac{\text{Tax-Exempt Assets}}{\text{Total Assets}} = 1 - Q$$

where, $Q = \dfrac{(t - tm)\, r_c + tm\, r_i}{(t - tm)\, r_t + tm\, r_i}$

where, r_c and r_t are as before, r_i is the average interest cost of funds borrowed, t is the normal corporate marginal tax rate, tm is the proposed minimum tax, and (E/A)** is the desired proportion of tax-exempt assets under the new minimum tax.

To the extent that banks are maximizing after-tax profits, it can be shown that the change will reduce bank holdings since

$$\frac{r_c}{r_t} < \frac{(t - tm)\, r_c + tm\, r_i}{(t - tm)\, r_t + tm\, r_i} .$$

Therefore,

$$1 - (r_c/r_t) > 1 - Q, \quad \text{and,} \quad (E/A)^{*} > (E/A)^{**}.$$

Thus, the optimal tax-exempt holdings are greater under the existing treatment than they would be under the corporate minimum tax. We can test the predictive quality of this formulation and examine the impacts of the proposed change by using actual values for the above variables to calculate predicted bank holdings of tax-exempt securities.

Table 2 presents a series of calculations that compare actual tax-exempt security holdings of commercial banks (E/A) for the period 1975 through 1980, with those predicted using the formula under the current tax treatment, (E/A)*, and under the proposed tax treatment, (E/A)**.[2/] As may be seen by comparing Columns 1 and 2, the predicted percentage holdings in tax exempts track the actual holdings very consistently and only slightly overestimate actual holdings during the period.

[2/] Column 1 figures for bank holdings and total financial assets are taken from the Federal Reserve Board, Flow of Funds Accounts, Assets, and Liabilities Outstanding 1957-80 (September 1981).

Column 2 is calculated using the formula $(E/A)^{*} = 1 - (r_c/r_t)$.

Column 3 is calculated using the formula:

$$(E/A)^{**} = 1 - \frac{(t - tm)\, r_c + tm\, r_i}{(t - tm)\, r_t + tm\, r_i} .$$

r_c, r_i, r_t are taken from the 1981 Annual Report of the Federal Deposit Insurance Corporation (FDIC). Also, $t = .46$ and $tm = .15$.

TABLE 2

Actual and Estimated Holdings of Tax-Exempt Securities as Percentages of Total Bank Financial Assets

	Column 1 (E/A) Actual Tax-Exempt Securities As % Of Total Assets	Column 2 (E/A)* Predicted T.E. Holdings Under Present Tax Treatment as % of Total Assets	Column 3 (E/A)** Predicted T.E. Holdings Under Minimum Tax Proposal (15% note) As % Of Assets
1975	12.46 %	13.47 %	9.64 %
1976	11.90	12.26	8.93
1977	11.65	12.86	9.40
1978	11.17	13.23	9.73
1979	10.80	11.91	8.62
1980	10.76	10.21	7.27
Avg.	11.46 %	12.32 %	8.93 %

Note: The predicted percentages of tax-exempt holdings in Column 2 are, on average, slightly greater than the actual percentage holdings in Column 1. The proposed change would lower the predicted holdings (Column 3) of tax exempts. Assuming that actual tax-exempt securities would retain their proportionate relationship to the predicted levels implies that actual holdings of tax exempts as a percentage of total bank assets would drop as follows:

$$\frac{11.46}{12.32} = \frac{x}{8.93}, \quad x = 8.31\%$$

Thus, the actual holdings are projected to drop by 3.15 percentage points (11.46 - 8.31) or by 27.5% (3.15/11.46) based on the 6-year experience reported above.

Column 3 gives the predicted percentage of assets in tax exempts, had the proposed minimum tax on allocated interest deductions (at a 15 percent rate) been in effect. It, too, tracks nicely the figures in the previous two columns, but at a uniformly lower level. On average, as indicated in Table 2, it would have produced a desired ratio of tax-exempt to total assets 3.15 percentage points lower than that actually observed, if we were to assume that actual holdings were to behave proportionately under the proposed tax treatment as they have to the existing tax treatment of nonallocation of interest costs. This would have meant a 27.5 percent drop in the optimal level of bank holdings, were the banks' respective average rates of overall costs (r_c), borrowing costs (r_i), and taxable investment earnings (r_t) to have been in effect.

To calculate the dollar magnitude of the 27.5 percent decline in tax-exempt holdings, we need to take this change in ratio to the dollar amount bank holdings as of the end of 1982. Since these were $155 billion, the estimated new holdings would be $112 billion. Other realistic estimates of the size of the reduction in holdings are possible, but do not differ greatly in magnitude given the facts and formulations as set out above.[3/] Such a reduction -- approximately $43 billion -- in bank holdings would be of enormous consequence. That amount represents almost the equivalent of one year's

---

[3/] Alternative interpretations of adjustment from the current level of desired tax-exempt holdings are possible. For example, it is estimated that tax-exempt securities represented 10.3 percent of bank assets at the end of 1981. Assuming that this represented 95 percent of the desired ratio (as in 1980) under the current treatment and that, under the proposed changes, the new desired ratio would be about 71 percent of the former, the new desired ratio would be about 6.9 percent in tax exempts. This would represent a 3.4 percentage point (or 33 percent) decline in the desired holdings of tax exempts. Since banks hold $155 billion in tax-exempt securities, the 33 percent decline would mean a $51 billion decline in desired holdings to a level of $104 billion.

entire new offerings of long-term debt and approximates almost twice the size of recent net increases in tax-exempt debt outstanding.

Impact of Reduced Bank Demand on Tax-Exempt Interest Rates

The second issue to be resolved is to estimate the effect of banks' reducing their holdings of municipal bonds on tax-exempt interest rates and the activity of the tax-exempt securities market in general. A useful starting point is to consider the "surplus" of $43 billion in bank-held, tax-exempt debt as an increment in supply to be absorbed elsewhere in the market. Prior research has estimated that each billion in new supply of tax-exempt debt (holding other factors constant) increases tax-exempt rates by 3 to 5 basis points.[4/] Thus, $43 billion in "unwanted" municipals might be expected to increase tax-exempt rates on the order of 120 to 200 basis points (using 20-year bond yields as the index), with 160 basis points providing a mid-point estimate. The final observed effect would depend on many factors, including the sensitivity of new offerings to the upward surge in interest rates (elasticity of supply of new debt) and the speed with which banks would seek to achieve their new desired level of holdings.

On the latter point, it should be noted that banks hold relatively short maturities, dominating the tax-exempt note market and having a large volume of long-term bonds maturing each year.

In an attempt to shed more light on the impact of the change in bank holdings on tax-exempt rates, several statistical estimates were used to derive direct evidence. The general approach is to explain the level of tax-

---

[4/] For a review of recent studies regarding the interest rate effects of incremental supplies of tax-exempt bonds, see Ronald Forbes, et al., "An Analysis of Tax-Exempt Mortgage Revenue Bonds," Municipal Study Group, State University of New York at Albany (May 1979) Appendix III.

exempt rates in relationship to taxable security rates by the composition of asset holdings by major investor groups and the total volume of tax-exempt securities outstanding in relation to total privately held credit market instruments in the economy.[5] Specifically, we can test if there is any statistical relationship between the ratio of tax-exempt to taxable rates, shares of tax-exempt securities in investor portfolios, and the amount of tax exempts outstanding relative to total credit in the economy. In order to minimize certain estimation problems and to focus on changes in the key variables, statistical regressions were estimated in first-difference form. Annual data were used for the period 1960 through 1981.

In Equation 1 in Table 3, the change in the ratio of rates, (RE/RT)', is a function of the change in the percentage of bank financial assets in municipal securities, (MSbc/FAbc)', and the change in municipal securities as a percentage of total credit market instruments in the economy, (MS/CMI)', where the prime (') indicates a change in the ratio. As expected, the ratio of rates is negatively related to increases in the percentage of bank assets in tax-exempt securities. It is positively related to the total amount of tax-exempt debt as a percentage of credit market instruments (but the relationship is not statistically significant). The constant in the first-difference formulation is equivalent to a positive time-trend in the ratio which is not attributable to the portfolio variables also found in the equation.

Equation 2 is a similar formulation, but one which seeks to explain further changes in the ratio of rates by taking into account the changing portfolio composition of the two other major investors in tax exempts, property and casualty insurance companies, and households (MSpc/FApc) and (MChh/CMhh),

---

[5] The financial asset data used are from the Federal Reserve Board, Flow of Funds Accounts. The rates used are those defined in Table 1 above.

Equation 1

TABLE 3

Dependent Variable: (RE/RT)'

Independent Variables	Coefficient	Standard Error
Constant	.0051	—
(MS/CMI)'	.0362	.0516
(MScb/FAcb)'	- .0333	.0167

R^2 = .1920

standard error = .0395

period = 1960 to 1981 (annual)

(/)' = change in ratio in percentage points

Equation 2

Dependent Variable: (RE/RT)'

Independent Variables	Coefficient	Standard Error
Constant	.0137	—
(MS/CMI)'	.0284	.0556
(MShh/CMhh)'	.0092	.0106
(MScb/FAcb)'	- .0343	.0170
(MSpc/FApc)'	- .0100	.0036

R^2 = .5568

standard error = .0309

period = 1960 to 1981

(/)' = change in ratio in percentage points

Equation 3

TABLE 3 (Continued)

Dependent Variable: (RE/RT)

Independent Variable	Coefficient	Standard Error
Constant	.4562	—
(MS/CMI)'	.0500	.0430
(MShh/CMhh)'	.0136	.0083
(MScb/FAcb)'	- .0215	.0135
(MSpc/FApc)'	- .0077	.0029
$(RE/RT)_{t-1}$	.3727	.0430

R^2 = .6706

standard error = .0237

period = 1960 - 1981

(/)' = change in ratio in percentage points respectively). Explicit treatment of the other investors' portfolios improves the explanatory power (and agrees with expectations) but does not change to any degree the incremental effects of changes in bank holdings as found in Equation 1.

The results indicate that a one percentage point change in the percentage of bank assets in municipal securities will generate approximately a 3 percentage point change in the ratio of tax-exempt to taxable rates. Thus, were the ratio at .70 (approximately the average for the period), a one percentage point decrease in the proportion of bank assets in tax exempts would increase the ratio to approximately .73.

Equation 3 provides a slightly different formulation, whereby the ratio of rates itself is made a function of changes in asset composition, changes in the overall supply of tax exempts to total credit market instruments, and the previous year's ratio. This essentially argues that the ratio of rates this year is a function of last year's rate and changes in total relative supply and investor portfolios. Under this lag formulation, it can be assumed that there is a period of "adjustment" in the ratio to new levels as portfolios undergo change. The results imply that the first year's adjustment in the ratio would be .021 (2.1 percentage points) in response to a one percentage point change in bank portfolios. The final effect (long-term equilibrium) would be approximately a 3.4 percentage point change in the ratio, other things being constant.[6/]

The above statistical results can be coupled to the previous estimates of changes in bank holdings to estimate the impact of bank withdrawl from the tax-exempt market on tax-exempt interest rates. As a result of the

---

[6/] $-.0343 = -.0215/(1 - .3727)$

minimum tax, bank holdings of tax exempts would shift down by approximately 3 percentage points. At 3.33 percentage points increase in the ratio per percentage point decrease in bank holdings of tax-exempts as a percentage of financial assets, this means a total upward shift of approximately 10 percentage points in the ratio of rates (3 x 3.33). At current long-term interest rate levels (see Table 1) and assuming the taxable rate remained fixed at 16 percent, this would result in an increase of approximately 160 basis points in tax-exempt interest rates $(RE' = (RE/RT)' \times \overline{RT})$.

Both on the basis of previous analysis and the statistical results used in this analysis, a 160 basis-point increase in tax-exempt interest rates appears to be a reasonable mid-point estimate of the likely impact of imposing the minimum tax as it relates to tax-exempt securities.

Increased Cost of Borrowing

The overall impact of the increases in tax-exempt interest rates on the borrowing costs of issuers will depend on the volume of tax-exempt securities that are sold. Recently, total reported new issue sales have been in the vicinity of $80 billion a year ($50 billion long-term and $30 billion short term). If we use the mid-point estimate of 160 basis-point increase in tax-exempt rates, this would translate into $1.28 billion in added borrowing costs for the first year. Since the long-term bonds will be outstanding for many years (say, 10 years on average), the total added cost of borrowing would be much greater during the period the bonds were outstanding.[7/]

[7/] If we assume $50 billion in long-term borrowing (with an average 10-year life on new debt) and $30 billion in short-term debt issuance, then the present value of the added lifetime cost of the first year's borrowings would be, discounted at 12 percent, approximately $5.5 billion.

There are, of course, numerous caveats that can be made in interpreting these results. For example, issuers may choose not to sell as much debt in the face of high interest rates (but there is, in that case, an opportunity cost in terms of foregone public improvements); future tax-exempt rates may not go up by as much as the past would imply as alternative markets are developed (but the overwhelming importance of bank demand to the tax-exempt market argues against that); many uses of tax exempts are not truly "public" in that they finance private activities (but that is a separate question relating to the propriety of certain present uses of Federal tax exemption).

It is true that not all of the added costs would be borne by governmental taxpayers and rate payers. While precise data are lacking, it would appear that, of regularly reported tax-exempt issues, approximately 25 to 35 percent of tax-exempt borrowing ($14 to $19 billion) represents aid to private business, homeowners, and non-public hospitals.[8/] But even lowering the total borrowing cost impacts to two-thirds of those described above (the interest rate impacts remain the same since they depend on the total supply of tax-exempts, not just those offered by governments), still leaves an added annual interest cost burden of $850 million per year that must be met by increased taxes and charges.

This added $850 million in state and local borrowing costs should be weighed against the added $144 million that the Treasury evidently plans by 1984 to obtain from banks by imposition of the new corporate minimum tax

---

[8/] This does not include approximately $8 billion (of an estimated total of $10.5 billion) small-issue industrial development bonds that are not counted in nationally reported borrowing figures.

provisions.[9] Were almost all of the $144 million revenue increases attributable to taxing the interest deduction preference item, the ratio of increased borrowing costs for state and local governments to added revenues to the U.S. Treasury would be on the order of 5.9 to 1.[10] In other words, for every dollar in added Federal tax receipts, state and local governments would need to increase their taxes, fees, and charges by $5.90. The inefficiency and inequity of such a solution to the Federal budgetary gap — not only passing it on for states and localities to close, but multiplying it nearly 6 times in the process -- are both remarkable and depressing.

---

[9] According to the information released by the Treasury Department on February 26, 1982, the minimum income tax proposal would be expected to produce additional federal revenue of $4.8 billion in 1984. This, added to the current minimum income tax collections, would produce a total of $5.3 billion in that same year. The Treasury Department estimates that 2.9 percent of the minimum income tax will be collected from banking institutions, or approximately $153 million in 1984. At present, banks pay only about $9 million in minimum income taxes. Thus, the proposed changes would increase collections by $144 million.

[10] To the extent that other tax-preference items of banks account for the added revenues, the ratio of increased borrowing costs added receipts would be proportionately higher.

Mr. **Rangel**. Now Mr. Clyde.

STATEMENT OF LARRY F. CLYDE, CHAIRMAN, PUBLIC SECURITIES ASSOCIATION, AND EXECUTIVE VICE PRESIDENT OF CROCKER NATIONAL BANK

Mr. **Clyde**. Thank you, Mr. Chairman.

I am Larry Clyde. I am chairman of the board of Public Securities Association, PSA, the national association representing both banks and securities dealers that underwrite, trade, and sell State and local government securities and Federal securities.

My remarks today will address effects on the municipal securities market of two tax proposals contained in the administration's 1983 budget, the corporate minimum tax, and the restrictions on industrial revenue bonds.

We will address only one aspect of the administration's minimum tax proposal. This is the limitation on the tax deduction taken by banks and other financial institutions for interest paid on deposits to the extent that they hold municipal securities.

PSA is deeply concerned by the implications of this proposal since it will significantly reduce the future participation of commercial banks as investors in tax-exempt bonds. We estimate that this proposal will cost State and local governments at least $1 billion in higher interest rates in the first year alone.

Maintaining commercial bank demand for municipal securities is critical to the future of the municipal securities market. At the end of 1981, commercial banks held about 42 percent or $150 billion of outstanding municipal bonds.

Any proposal which severely reduces the net after-tax yield of these investments for banks could drive this market's largest single investor to other available forms of investment. Moreover, the retroactive application of this proposal will create uncertainty among all investors in these securities.

It will force them to require a margin of safety against further retroactive tax intrusions. Therefore, all investors will demand higher rates on new purchases of municipal bonds.

Some Members of Congress have also proposed broadening the minimum tax to include interest earned on municipal securities by corporations and individuals.

This direct form of taxation of State and municipal securities would not only devastate the municipal market, but in our opinion would be unconstitutional.

It is important to note that when a minimum tax including interest earned on municipal bonds passed the House of Representatives in 1969, investor confidence in the tax-exempt feature of municipal bonds was shaken. Tax-exempt interest rates quickly approached rates on taxable bonds. We would not like to see that history be repeated.

The administration has also proposed new restrictions on the controversial small-issue industrial revenue bonds. Unfortunately, these restrictions would also apply to bonds issued for traditional public purposes such as ports, mass transportation facilities, airports, and bonds issued for charitable and educational organizations.

PSA supports the right of State and local governments to issue tax exempts for public purposes in accordance with State law. However, we recognize that small-issue IRB's have had an adverse effect on the market. Therefore, we have urged States to curtail their use.

Our association believes that any changes in Federal law should be limited strictly to small-issue IRB's and should be directed toward the corporate beneficiaries of these financings.

PSA strongly opposes the administration's proposal to restrict tax-exempt bonds for exempt activities and charitable and educational purposes. The 1968 legislation establishing the current statutory provisions for municipal securities expressly recognized the public purposes achieved by the exempt activities listed in the statute. Moreover, these public purpose IRB's which have built infrastructure and public works facilities already comply with public use requirements established by the Treasury.

These bonds have financed a wide variety of vital public purpose projects such as construction of multifamily housing for low-income families or the elderly. Construction of hospitals owned by charitable nonprofit organizations, and port development through dock and wharf construction, and boat channel dredging.

The oversight subcommittee of this committee held hearings and issued a report in 1981 which recommended restrictions on small-issue IRB's only.

While we may differ on the best approach to limiting small-issue bonds, we believe that no record has been established to go beyond the small-issue area. We urge the committee to reject the administration's far-reaching proposal.

In closing, we would like to reiterate that the adverse effects on the municipal securities market of last year's tax revisions pale by comparison to the devastating consequences of this year's proposals.

Participants at all levels of this market will suffer, most particularly State and local issuers and the investors. We urge the committee to reject these proposals and thus preserve this market which has served this country's State and local governments so well over the years.

Thank you.

Mr. RANGEL. Thank you, Mr. Clyde.

[The prepared statement follows:]

STATEMENT OF LARRY F. CLYDE,* CHAIRMAN OF THE PUBLIC SECURITIES ASSOCIATION

INTRODUCTION

Mr. Chairman, and members of this distinguished Committee, I appreciate this opportunity to present the views of the Public Securities Association (PSA) on the tax proposals directly affecting the public securities markets contained in the Administration's Fiscal Year 1983 Budget. PSA is the national trade association representing banks, dealers and brokers that underwrite, trade and sell state and local government securities and U.S. government and federal agency securities. Our membership of approximately 300 firms collectively account for approximately 95% of the Nation's municipal securities industry underwriting and trading activity. In addition, 34 of the 35 primary dealers in government securities, as recognized by the Federal Reserve, are PSA members.

We expect to continue both underwriting and distributing state and local government securities whether or not the Congress enacts the Administration's tax proposals. Accordingly, we believe we can be reasonably objective in appraising the capital market and economic effects of these proposals insofar as they relate to state and local government securities.

---

* Mr. Clyde, who is Executive Vice President of Crocker National Bank, is Chairman of the Board of Directors of the Public Securities Association.

My remarks will address the effects on the public securities market of three particular tax proposals contained in the Reagan Administration's 1983 Budget. These proposals involve creating a new corporate minimum tax which would include as a "special deduction" the tax deduction taken by a bank or other financial institution for interest paid on borrowings to the extent it holds tax-exempt state and local government securities; the proposal to add a new set of conditions to the use of tax-exempt bonds for what were heretofore considered traditional public purpose activities and, the proposal concerning withholding on interest and dividends.

The Public Securities Association is deeply concerned with the implications of these proposals particularly as they bring into question the very future of the concept of the tax exemption for state and local government securities. We are also disturbed that these proposals are being debated at a time when states and local governments are being asked to shoulder increased fiscal responsibilities.

PSA shares this Committee's concern over the size of projected budget deficits; however, we believe that the Congress must seriously consider the implications of these proposals to the extent that they represent an abrogation of the Constitutional doctrine of reciprocal immunity. We recommend that the Congress carefully consider the devastating impact of these tax revisions on the ability of state and local governments to meet their financial objectives by borrowing in the municipal securities market.

The municipal securities market has served this country's state and local governments well over the years by providing low cost capital to meet the needs and general welfare of all their citizens. We believe that these proposals now bring into question the very future of this historically independent marketplace. A brief overview will help you gauge the importance of this market to our capital market system.

OVERVIEW OF THE MUNICIPAL SECURITIES MARKET

At present, the municipal bond market is the fourth largest sector of the domestic capital markets, accounting for approximately $356 billion, or just over 10% of all medium and long-term securities outstanding. The importance of this market may not only be measured by its size, but also by its social utility: the broad access it provides state and local governments to raise funds in the public capital markets at reasonable rates and in an expedient and orderly fashion. The funds raised in the capital markets by state and local governments are used to finance the cost of such critically important projects as schools, highways, ports, bridges, hospitals, airports, mass commuting and parking facilities, and sewage and waste disposal facilities.

The new issue market for municipal securities for 1981 reached $85.2 billion, surpassing 1980's record 12-month volume of $76 billion. The sensitivity of the market to the present interest rate environment is evidenced by the increased use of short-term financing. In 1981, short-term volume increased to $37.7 billion, up 35.8% from 1980, an all time record. Annual average borrowing costs stood at 10.77% compared with a 1980 annual average of 8.66%.

Traditionally, yields on municipal securities have ranged from 65% to 70% of taxable securities with equivalent rating and maturity. During 1981, however, the spread between 20-year AAA corporate bonds and 20-year AAA municipal bonds narrowed to 73.4%. This compares to a spread of 65.6% for 1980. Even more disturbing, however, is the fact that during December, 1981, the spread narrowed to 82.2%. Although this unprecedented reduction in the spread is not expected to be permanent, it does indicate that the municipal market is faring worse than other capital market sectors under the current strain of high interest rates.

The upward pressure on rates in the municipal securities market appears likely to continue in 1982 as the supply of securities will remain high relative to softening demand by investors. In addition, many of the tax law changes adopted as part of the 1981 Tax Act continue to have adverse effects on the market. These changes include the ill-advised, tax free "All Savers Certificates," the reduction in maximum tax rates, and the incentives for leasing and individual retirement accounts. However, the negative effects of last year's tax revisions pale by comparison to the likely impact of the Administration's new set of proposals. Participants at all levels of the market will suffer: the issuer, through overly restrictive prescriptions on the type of tax-exempt bonds it may issue, the corporate bank investor, through indirect taxation of its holdings of municipal securities and the municipal securities dealer, through added reporting and withholding requirements.

Let us first examine the new corporate minimum tax and its likely effects on the municipal securities market.

THE IMPACT OF THE CORPORATE MINIMUM TAX ON THE MUNICIPAL SECURITIES MARKET

The Administration has proposed a new alternative corporate minimum tax to replace the current add-on minimum tax. The new alternative minimum tax on "corporate profits" in excess of $50,000 would be required to be paid only if it exceeds the regular corporate income tax. We will address only one particular provision of this proposal, which we believe, alone, will have a severe adverse effect on the entire municipal market.

The Administration has recommended that corporate profits be calculated by adding back to a corporation's taxable income a series of special deductions which include deductions presently permitted commercial banks and certain other financial institutions for interest paid on deposits where the corporation holds tax-exempt securities. The Treasury Department has stated that in determining the amount of interest deduction to be added to the minimum tax base, the corporation's total interest deductions will be allocated pro rata across its total investment portfolio.

The Public Securities Association is deeply concerned by the implications of this proposal, since it will significantly reduce the future participation of commercial banks as investors in tax-exempt municipal bonds and consequently will substantially increase state and municipal borrowing costs. We estimate that this proposal will cost state and local governments approximately $1 billion in the first year alone.

Of even greater importance is the fact that this proposal represents an indirect form of taxation on the obligations of state and local governments. This would represent an irreparable breach of the Constitutional and historic wall of reciprocal immunity which heretofore has generally prevented state taxation of federal debt obligations and, conversely, federal taxation of state and local obligations.

Maintaining commercial bank demand for municipal securities is critical to the future of the municipal securities market. Of the $356 billion of municipal debt outstanding at the end of 1981, we estimate that commercial banks held approximately 42% or $150 billion. It is clear that any proposal which severely reduces the net after-tax yield and consequently the net income value of these instruments for banks will have substantial effects on the entire municipal market.

With the other opportunities for sheltering income through alternative investment vehicles, and their increased sensitivity to price volatility, it is reasonable to anticipate that this proposal will result in an immediate and substantial diminution in commercial bank investments in municipals. This could undermine the future viability of the municipal market. It will undoubtedly drive this market's largest single purchaser to other available forms of investment. The Municipal Finance Officers Association has estimated a 20-30% decline in total commercial bank demand for municipal securities as a result of this proposal.

We are also deeply concerned with the proposal's retroactive application to all outstanding tax-exempt securities held in the investment portfolios of commercial banks and other financial institutions. The investment decisions to purchase these securities were made years ago, under economic assumptions based on existing law, under which banks accepted relatively low rates of return on their investments in municipal securities. We believe that the retroactive application of this proposal, which will essentially change the tax law in effect when the municipal securities were purchased, will create uncertainty among all investors in these securities. It will force them to require a margin of safety against further retroactive tax intrusions by demanding higher rates on all new purchases of state and municipal securities.

Worthy of particular note is the fact that this proposal redefines bank deposits as a form of bank borrowing. Traditionally, the tax law has not viewed the normal deposit taking functions of banks as forms of borrowings. This redefinition could have broader implications which go beyond the intention of the Administration in submitting this proposal.

It is critically important for this Committee to recognize that tax exemption is not a gift from the federal government. It is a quid pro quo for the acceptance of lower rates of return than the investor could obtain on alternative investments. An investor in tax-exempt bonds has historically accepted bonds which offer significantly less interest income than he could receive from taxable securities. This represents the consideration he has paid for the tax exemption. Thus, in a very real sense, and certainly in terms of equity, the investor in tax-exempt bonds has already paid a tax.

From the perspective of state and local governments, this proposal represents another in a series of recent federal actions which are continuing to promote upward pressure on municipal borrowing rates. For example, the fundamental realignment of federal, state and local responsibilities being proposed under the Administration's "New Federalism" initiative, the severe budget reductions in federal assistance to state and local governments and several provisions of the 1981 Tax Act, taken together, are exacerbating the burdens of high interest rates on the municipal securities market.

To the degree that interest on tax-exempt municipal securities is compromised as part of a minimum tax proposal, all state and local governments will be required to pay more for their future borrowings. These added borrowing costs mean higher state and local taxes for all citizens. In fact, the reaction of the municipal market, in all likelihood, will be so severe that the increases in state and local taxes could more than offset any federal revenue gain.

The municipal bond market already experienced similar results when minimum tax legislation that included a tax on municipal interest passed the House of Representatives as part of the Tax Reform Act of 1969. By late August, 1969, the market for municipal bonds suffered a severe dislocation and near collapse. Many local governments were unable to issue bonds at rates within the maximum limits fixed by their controlling state finance laws. It was also difficult to find realistic bids for bonds which investors wanted to sell. We certainly do not want to witness a repeat of the 1969 experience, particularly now, when the municipal market is already suffering under the strains of unprecedented interest rates.

We also understand that Congress is seriously considering broadening the current minimum tax proposals to include interest earned on municipal securities by corporations and individuals. In our opinion, this more direct form of taxation of state and municipal securities would not only be unconstitutional, but in tandem with the proposed corporate minimum tax devastate the entire municipal market.

In conclusion, PSA opposes imposition of a direct minimum tax upon the interest income from state and local government securities. PSA believes that any such action would cause severe problems in the marketing of such securities and would increase the borrowing costs of state and local governments. We also oppose the indirect tax on municipal bond income proposed by the Administration. We believe that it would effectively remove commercial banks from the municipal market and would cause uncertainty over the status of the tax exemption among all investors.

We have already described the reasons why we believe that the Administration's minimum tax proposal will raise state and local borrowing costs. Let us next examine the set of prescriptions that are recommmended in the use of tax-exempt bonds for private activities. PSA believes that this proposal, to the extent that it restricts industrial revenue bonds for "exempt activities" and other traditional public purposes will handcuff state and local issuers and prevent them from meeting the public needs of their citizens.

THE ADMINISTRATION PROPOSAL TO RESTRICT PRIVATE AND PUBLIC PURPOSE INDUSTRIAL REVENUE BONDS

The Administration's proposal regarding to industrial revenue bonds would restrict (1) small-issue industrial revenue bonds (IRBs), (2) IRBs used to finance specified exempt public purpose activities, and (3) financings for non-profit hospitals, educational institutions and student loans.

The original IRB statute was adopted in 1968 as part of the Revenue and Expenditure Control Act of 1968. The Act contains a general rule rendering the income on all IRBs taxable and then establishes several categories of tax-exempt industrial revenue bonds. A tax-exempt small issue IRB can be issued for up to $1 million and alternatively, for up to $10 million subject to capital expenditure limitations. The other exceptions in the present statute are for "exempt activities" and certain charitable and other non-profit institutions. Contained in this list of specifically enumerated activities, are projects for public use and benefit which historically have been undertaken by state and local governments.

It is important for the Committee to note that up to this point, all Congressional debate on the subject of industrial revenue bonds has been limited exclusively to small issue IRBs. For example, in announcing last April's hearings before the Ways and Means Subcommittee on Oversight, Congressman Rangel announced his intention "to establish a comprehensive record on the current use and effects of small issue industrial revenue bonds." These hearings resulted in the introduction of H.R. 4420, which, again, is limited to small issue IRBs. No such analysis or examination has been undertaken or is given in the area of exempt facility IRBs or tax-exempt bonds used to finance non-profit hospitals, educational institutions or student loans. The Administration has attempted to redefine and broaden the entire framework of the IRB debate, seeking to shift the focus from small issues by using the broad and inaccurate label "private purpose bonds." You should remain ever mindful of this tactic in reviewing their proposal.

The Administration has now proposed adding the following conditions to the use of all types of IRBs regardless of their ultimate use:

1) The restrictions generally would apply to what the Administration has characterized as "private purpose" bonds issued after December 31, 1982.

2) The costs of depreciable assets financed with the tax-exempt bonds could be recovered only by using straight line depreciation over an extended recovery period.

3) Small issue IRBs would be limited to small businesses (i.e., a company with capital expenditures of less than $20 million over a six-year period and no more than $10 million of IRBs outstanding).

4) Restrictions on permissible yield from investment of the proceeds of the obligations would be extended to reserve funds and funds held during the temporary construction period.

5) Each bond would be required to be in registered form, and information concerning the issuance of the obligations must be reported to the IRS.

6) After December 31, 1985, the state or local governmental unit would be required to make a contribution or commitment to the facility financed equal to one percent of the face amount of the bonds.

7) The highest elected official or legislative body would be required to approve the bonds after a public hearing.

Before discussing PSA's specific comments on the Administration's proposal, it may be helpful to present the Committee with our policy position on small issue IRBs.

> The Public Securities Association supports the right of state and local governments to issue tax-exempt securities for public purposes in accordance with state law. However, PSA believes that small issue industrial revenue bonds have had an adverse effect on the municipal securities market, and urges that state and local governments take positive steps to curtail their use.
>
> Our Association opposes federal legislation which would restrict the right of state and local governments to determine the public purposes for which bonds can be issued. We believe that any federal action concerning small issue IRBs should be limited only to the tax treatment of direct, private beneficiaries of the proceeds of small issue IRBs.

We believe the Administration's proposed choice between ACRS and tax-exempt financing is appropriate if, and only if, it is limited to direct private beneficiaries of small issue IRBs, we also believe that the same proposal as applied to "exempt activity" and charitable purpose tax-exempt bonds represents a form of restriction which compromises the rights of state and local governments to issue tax-exempt securities for traditional public purposes. We believe that these public purpose industrial revenue bonds, which have played a vital role in establishing and maintaining infrastructures and public works facilities for general public use and benefit should not be subject to the restrictions imposed by the Treasury. Recent controversy over IRBs has been limited to small issue financings. Any changes in federal law should be limited to that area.

The 1968 federal legislation establishing the current statutory provisions for state and local government securities contained such a broad definition of "industrial development bond" that any significant private involvement in a project could result in IRB status. Congress recognized, however, that these projects are financed in the municipal market because they involve facilities for public use and benefit or extensions of publicly used facilities. Consequently, Congress decided that tax-exempt financing of those projects was necessary and appropriate and should not be restricted in order to permit state and local governments to fulfill the general needs of the public. Special categories were therefore established to continue this financing for traditional public purpose projects, including airports, docks and wharves, mass commuting and parking facilities, sports or convention facilities, housing projects, water, electric, sewage and waste disposal facilities as well as for certain charitable and non-profit organizations.*

Today, municipal financing for such projects is essential for the construction or redevelopment of infrastructures and facilities necessary for the social and economic well being of all citizens. The fact that private parties may operate or otherwise benefit from these facilities simply reflects the historic practice of state and local governments in providing public works necessary to support and maintain residential communities and commercial and industrial development.

---

* In the 1968 statute Congress also authorized tax-exempt financing for pollution control facilities owned by private corporations. Although there is a public benefit associated with a cleaner environment, the proceeds of tax-exempt pollution control bond issues generally benefit a single corporate polluter. This exemption was added by Congress to the 1968 legislation to assist corporations in meeting federal pollution standards. PSA has a policy position in support of eliminating the use of tax-exempt municipal securities to finance pollution control facilities which are not owned and operated by local governments. PSA believes that the federal government should adopt other ways of assisting private industry in its efforts to meet federal environmental standards.

Public purpose is a continually evolving concept. If state and local governments are to accept increasing responsibility for meeting their own needs under the New Federalism, the private sector will be a necessary partner in such projects. This objective will be seriously impaired if Congress enacts the Administration's proposals which will jeopardize the flexibility of states and localities in choosing, consistent with determinations of public purpose under state law, the types of public works they will finance.

The economic needs of our states are far too varied and complex for the Treasury's proposal restricting exempt facility financing. This is clearly demonstrated by examining the following examples of financings to which these proposals would apparently apply:

1) A county agrees to issue bonds to extend public sewer lines to serve several private businesses;

2) A rural municipality issues bonds to build and equip a bus terminal which the private bus line will operate;

3) A city seeks to finance construction of new counter and hangar space at a municipal airport in order to bring commercial passenger service into the area;

4) A private company agrees to purchase 30 percent of the output from a certain power facility to be financed (the remaining output will be used by several municipal purchasers); and

5) As part of an urban renewal project, a city issues debt to finance construction of a parking garage which will be leased for operation by a private company.

These situations, and many others, represent what today are garden-variety public works projects. There can be little doubt, however, that Treasury and IRS would treat these cases as "private purpose" financings subject to the proposed new limitations.

ACRS Versus Straight Line Depreciation

The Treasury has proposed that a private participant be required to choose between the new, rapid depreciation system

(ACRS) and tax-exempt financing for project facilities it may be entitled to depreciate. We believe that given this choice, most private parties would decide to use ACRS. In effect, therefore, the proposal dictates that state and local governments may not issue debt to finance such projects unless the private participants compromise their own economic interests. Since tax-exempt financing will be an important factor in the private decision making process, the result in many cases will simply be to prevent the private participation necessary to make the state or local project economically viable.

In addition to requiring this "choice" (which in our view is not really a choice) between tax-exempt financing and ACRS by private participants in public projects, the Treasury Department proposal would impose other unwarranted restrictions on state and local public purpose projects financed with municipal bonds.

Arbitrage Restrictions

PSA opposes the broad new restrictions on investments of proceeds from the sale of tax-exempt state and local government securities proposed by the Administration. These new "arbitrage" restrictions would apply to any facility which the federal government did not regard as wholly public in nature and thus would adversely affect the whole spectrum of exempt facilities financings, as well as financings for tax-exempt hospitals, educational institutions and state student loan programs.

When Congress adopted the Tax Reform Act of 1969, it eliminated the statutory tax exemption for arbitrage bonds and imposed strict limitations on the investment of proceeds from the sale of municipal bonds. Arbitrage bonds are defined as bond issues in which the proceeds are used to acquire taxable securities that produce a materially higher yield than the yield on the tax-exempt bond issue. Once determined to be arbitrage bonds, securities are no longer tax-exempt.

The original arbitrage statute, however, included certain exceptions which expressly authorized unrestricted investment of bond proceeds (1) for a temporary period pending use in the project, or (2) in a reasonably required reserve or replacement fund not exceeding 15 percent of the bond issue. The Administration is now seeking to have both of these provisions repealed for the broad range of public purpose tax-exempt bonds issued to finance projects which the Treasury has mislabeled as "private activities."

PSA opposes these drastic changes in the arbitrage restrictions for the following reasons:

--The new restrictions will adversely affect a great number of projects which clearly provide public benefits;

--The restrictions will create shortfalls in amounts needed in connection with these projects. The shortfalls would have to be made up through unnecessary additional borrowing which, in turn, would swell the volume of municipal debt and further increase the costs of financing needed projects;

--The restrictions will be burdensome, counterproductive, and inconsistent with the efforts by the Administration to encourage greater self-sufficiency on the part of state and local governments;

--To achieve compliance with the new restrictions, the construction or reserve funds for bond issues would generally have to be invested in special U.S. Treasury securities bearing interest at substantially below market rates. The result would be pure subsidization of the federal deficit at the expense of state and local governments;

--The restrictions would involve a serious intrusion into the basic authority of state and local governments to determine whether projects serve public purposes;

--The current provisions represent Congressional recognition of the way in which municipal bond construction and reserve funds have traditionally been used.

Finally, the Administration has failed to demonstrate why it is necessary to reverse this sound and long-standing Congressional decision.

Registered Bonds

PSA opposes the Administration's proposal which would require that all tax-exempt bonds for "private activities" be issued in registered form. There are several reasons why we do not support this recommendation:

--First, such requirement could create a two-tiered municipal securities market, the first tier consisting of outstanding bearer securities and the second tier consisting of new issue registered securities. The creation of a two-tiered system would fundamentally alter the structure of the municipal securities market and even more importantly, could increase borrowing costs for state and local governments seeking to raise new capital. We anticipate that issues of smaller size will be particularly affected.

--Secondly, registration could add operational and administrative burdens to municipal securities dealers which could slow the velocity of trading activity thus increasing the risk of taking positions in the market and further stimulating price volatility.

--Lastly, efforts to establish automated systems of municipal security clearance and comparison are still in the trial stage as are current efforts to establish a municipal security depository environment. Their establishment and effective operation are some time away. For these reasons, we believe that benefits to the federal government resulting from a registration requirement at this time would be outweighed by the costs to state and local governments and the burdens it would place on the market.

Consequently, PSA believes that it would be particularly inappropriate, at this time, for the federal government to require that state and local governments radically change the manner in which they issue municipal securities. Moreover, irrespective of current economic conditions, we believe that market participants and not federal tax law should determine the most efficient manner to issue and trade municipal securities.

One Percent Local Contribution

The Administration has proposed that, after December 31, 1985, the local governmental unit in which a project financed with tax-exempt bonds is located, make a financial contribution or commitment to the facility equal to one percent of the face amount of the bonds.

PSA is concerned that this proposal would adversely affect tax-exempt financing in many states. Over 20 states have Constitutional or statutory prohibitions which preclude the making of loans, the extension of credit or the granting of abatements or exemptions to any type of private corporation. For this very reason, many states created independent authorities and public benefit corporations which are established to facilitate the promotion of economic development and to meet the public needs of their citizens. The enactment of this proposal would force states to either amend their Constitutions (a very formidable task) or eliminate the use of tax-exempt financing for "private activities" after 1985. This is an undesirable result and certainly one which is beyond the stated intent of the Administration in recommending this legislation.

WITHHOLDING ON INTEREST AND DIVIDENDS

The Administration has proposed that a flat rate tax of 5 percent be withheld from interest and dividend payments made to individuals. The reasons for PSA's opposition to this proposal may best be summarized by reference to the resolution adopted by the Committee on Finance in 1980 (S. Con. Res. 92)(Senate Report No. 96-863, 96th Congress, 2nd Session, July 23, 1980), which reads in pertinent part:

> Since the current system of withholding on wages and salaries was initiated, there have been several proposals for extending withholding to interest and dividend payments. The Committee has never approved such proposals in the past and it is the judgment of the Committee

that it will not approve any such proposal now. The Committee is concerned that the proposal to withhold income tax on interest and dividend payments could work hardships on those individuals least able to afford them, such as retirees who depend on social security and dividend and interest income. In addition, the Committee believes that the proposed exemptions from withholding, which are designed to make the system more equitable, would make the withholding system unacceptably cumbersome and costly to administer. Because of these concerns, the Committee has reported this resolution which affirmatively states that it is the sense of the Congress that the enactment of a withholding tax on interest and dividend payments would be detrimental to the economic well-being of the United States.

The Administration's proposal would impose a withholding requirement for payments of interest to all individuals who purchase bills, notes and bonds issued by the U.S. Treasury and federal agency obligations. The Committee should note that individuals have played an increasingly important role in the government securities market and can be expected to in the future. We estimate that "households" now hold over $200 billion of outstanding Treasury debt.

We are all keenly aware of the enormous borrowing requirements of the Treasury in the years ahead, particularly since it will be seeking to finance projected deficits which may exceed one quarter of a trillion dollars between now and fiscal year 1985. Therefore, it does not seem logical to be promoting legislation whose effect will be to drain investable funds from the household sector of investors at a time when they will be increasingly relied on to finance the federal debt.

Implementation of the Administraton's withholding proposal would also result in significant operational costs for the dealers and dealer banks in government securities which would act as withholding agents for the Treasury. Unlike interest on savings and corporate dividends, there is currently no information reporting system in place for interest earned on government securities. The basic record-keeping system for most dealers in government securities consists of customer confirmations of purchases and sales. The costs of implementing withholding and processing exemption certificates will have to be passed on to investors, reducing their return on investments.

For these reasons, PSA opposes the withholding on interest and dividend proposal. We believe that taxpayers who save and invest are promoting the goals of the Administration's overall economic recovery plan and therefore should not be subjected to additional withholding requirements.

Before closing, I would also like to note our concern with S. 2198, a bill recently introduced by Senators Dole, Grassley and Chafee and soon to be introduced in the House by Representative Conable. This bill would expand information reporting requirements of brokers and dealers to include interest payments on U.S. Treasury and Federal agency obligations, and would further require reporting of capital gains realized on all securities transactions. This proposal presents similar administrative, operational and programmatic difficulties to those arising from the Administration's withholding proposal. We believe the time and costs of implementation, (which will be ultimately borne by the investor) will outweigh any revenue gains to the Treasury and therefore do not support its adoption.

Conclusion

PSA believes that the Administration's tax proposals, if enacted, could prove to be the death knell of the municipal bond market. The inclusion in a new minimum tax of an indirect tax on municipal bond holdings of commercial banks, the largest single investor in municipal securities, will substantially reduce, if not discontinue their purchasing of new issue municipal bonds; at the same time, the retroactive application of this tax law change could cause them to sell off much of their portfolio investments in municipal securities. This will drive bond prices down, force yields up, and make it increasingly burdensome for state and local governments to borrow to finance their growing needs.

If the rules of the game can be changed in relation to outstanding bonds in the hands of corporations, other investors will logically conclude that the rules could be changed for them as well. Therefore, they will demand a margin of protection against further deterioration in the value of securities they hold, adding further upward pressures on state and local borrowing costs.

The Administration's restrictions in the area of public purpose exempt activity financing, if enacted, will also have a disruptive effect on the market. These broad and overly restrictive requirements will adversely affect an area of financing which, by all traditional definitions, has fulfilled public need and public purpose. There has been no demonstration of any need to make corrections outside of the current provisions for small issue IRBs.

In closing, we would like to reiterate that the adverse effects on the municipal securities market of last year's ill-advised, tax-free "All Savers Certificates," the reduction in maximum tax rates, and the incentives for leasing and retirement accounts, pale by comparison to the devastating consequences of this year's set of proposals. Participants at all levels of this market will suffer, most particularly state and local issuers and the investor. We urge the Committee to reject these proposals and thus preserve this market, which has served this country's state and local governments so well over the years.

Thank you.

Mr. **Rangel**. Mr. Robert Patterson for the Massachusetts Industrial Finance Agency.

STATEMENT OF ROBERT E. PATTERSON, EXECUTIVE DIRECTOR, MASSACHUSETTS INDUSTRIAL FINANCE AGENCY

Mr. **Robert Patterson**. Thank you, I appreciate the opportunity to be here today because I believe it is time to look at the facts of not only the true benefits but true costs of the treasury revenue enhancement proposal.

I would like to share with you today the econometric study just performed by economists at the University of Massachusetts. They just completed a study of the economic impact of industrial revenue bonds for small businesses in Massachusetts.

These projects over the last 3 years have assisted 870 companies with slightly over $1 billion of industrial revenue bonds and they expect to add 47,000 new jobs and 18,000 man years of construction work.

I would like to point out, however, that for purposes of this econometric study, the assumption was that the true net effect on net new jobs was less than a third of the projected jobs. So there is plenty of softness in there for the critics.

If only 30 percent of the jobs were actually net new jobs in econometric terms, then the analysis showed that over the next 5 years these jobs would result in a total of over $300 million of increased Federal income taxes, $243 million in increased State taxes, and an increase of personal income of $2.9 billion.

We have heard a lot about the stresses on the municipal market but it is important to note that in our region of the country, local governments are almost totally reliant on the property tax. The over $1 billion of buildings constructed and renovated with this program in the last 3 years will pay over $60 million a year at local property tax levels.

Personally I find it incredible that the administration is blaming small-issue industrial revenue bonds for the state of the municipal market. I should point out that as recently as last April when the Congressional Budget Office study came out, it noted that the spread between taxable and tax-free interest rates had risen to 40 percent above the historical 30 percent. That was as recently as last April and that was, my friends, after industrial revenue bonds increased dramatically because of the effects of high interest rates on small companies.

Over the next 10 years, to summarize, this study showed that these new jobs will result in an additional $6.5 billion of personal income and $1.3 billion of additional State and Federal taxes. The Treasury, as I understand it, claims that the cost to the Federal Treasury is only $30 million a year per $1 billion. So the net effect appears to be positive.

This complements the CBO findings on page 96 of its study that if IRB's were allowed to continue, they would generate over $4 billion in gross national product and $2.2 billion of additional private wages and salaries in 1986.

While everyone has heard the stories about the K-Marts and McDonalds, let's try to separate rhetoric from fact. The rhetoric suggests that IRB's assist large multinational corporations, but the fact is that the CBO study found that bonds had been used overwhelmingly by smaller businesses.

For example, in recent years over 90 percent of all IRB's were issued for closely held firms not listed on any regional or national stock exchange and therefore dependent on local financing. Only 7 percent went to Fortune 1,000 companies, and only half of these issues exceeded $1 million.

In Massachusetts, three-fourths of the companies that have received bonds had sales under $20 million, and one-half had sales of less than $5 million. The majority of IRB recipients employ less than 100 employees in the State.

The rhetoric suggests that IRB's are inefficient and costly to the Federal Government and that the Treasury's restrictions are needed to "enhance" Federal revenues. Yet the fact is that even the Treasury projects a net revenue decrease in 1983 if its proposals are enacted. Last year the Congressional Budget Office projected that if IRB's were eliminated, the Government would raise only $200 million in 1982, rising slowly to $700 million in 1986.

Other studies, including one completed at the University of Chicago for the Massachusetts-based Smaller Business Foundation of America, question the Treasury's assumptions and show that by stimulating private investment IRB's may actually increase the Treasury's funds.

The concept that IRB's stimulate investment and actually raise tax revenues is hardly a crackpot notion. In 1980 a leading "supply side" economist, Dr. Norman Ture, studied IRB's and concluded that:

> IRB's are productive instruments for promoting economic development by making saving and investment more attractive to individuals and businesses * * * The resulting expansion of tax bases—individual, corporate and payroll taxes—would generate net gains in tax revenues for the Federal Government and for the State and local governments of the issuing jurisdictions.

As you know, Dr. Ture today is the U.S. Treasury's Under Secretary for Tax Policy.

The rhetoric suggests that IRB's are out of control with overly generous eligibility criteria. Yet the fact is that high interest rates have caused the increase in IRB financing in recent years, and that the "window of eligibility" has actually decreased dramatically as a result of inflation.

Today the $10 million company limitation per jurisdiction really buys over a quarter less plant and equipment in real terms than the $5 million limit enacted in 1968. Again, as the CBO noted, and I quote, "The $10 million capital expenditure limit effectively keeps most large corporations from making much use of small issues."

In Massachusetts, we have seen the importance of lowering interest rates through industrial revenue bonds to stimulate investment and more jobs. Projects financed with IRB's over the last 3 years promise to produce 47,000 new, permanent jobs and 18,000 man-years of construction work.

Do IRB's stimulate new investment? IRB recipients in Massachusetts were surveyed, and 85 percent responded that without the interest rate reduction afforded by IRB's they would have reduced or canceled their plant expansions.

One-third of the companies said that they would have canceled their expansion outright, another third would have delayed their growth, and one-fifth would have expanded less by an average of 42 percent.

The main trouble with the Treasury proposal is that they are attempting to eliminate small issue IRB's by making them unattractive and useless to small companies. Once a project has been financed under the Treasury's restrictions, it would not be eligible for the accelerated depreciation schedules. In other words, a company using an IRB—the only reasonably priced expansion capital available to smaller companies—would never be able to depreciate that plant according to the 1981 accelerated cost recovery schedules.

Where I part company from the Treasury is that I accept the fact that the benefits of IRB's have gone overwhelmingly to small companies, and I believe that those firms deserve the financing assistance IRB's afford to offset the disadvantages that small companies operate under in the financial markets. The Treasury's proposals would take away the advantage offered by IRB's, and as a matter of policy I am opposed to that.

Far better, I suggest, to approach the issue of IRB reforms from the perspective of the abuses. The abuses have been in the unrestricted use of IRB's for commercial real estate developments. It would be far better to adopt the Massachusetts approach of targeting these projects more along the lines of Congressman Rangel's bill which came out of the House Ways and Means Oversight Subcommittee hearings last year, although some adjustment to the criteria of "distressed areas" should be considered.

If Congress adopts the Treasury's proposals, however, there will be no benefit to smaller companies, and in the name of "reform" we will have lost IRB's for both our productive high-tech companies and our experienced developers willing to take on projects in our distressed areas.

Given what is happening to the budget, soon there will be no special assistance for distressed areas, and in a State like Massachusetts we cannot accept this result. I note that even the Treasury has agreed that industrial revenue bonds should be used to aid investment in distressed areas, although they want to limit this provision to "enterprise zones." Although the enterprise zone concept may offer promise, I suspect it will be far too narrowly defined to help many of the deserving distressed areas.

I urge Congress to carefully consider IRB reforms before passing them at a time of such incredible interest rates, growing unemployment, and fears of depression precipitated by the highest real interest rates in history. I cannot help recalling the pressured atmosphere in which the Treasury succeeded in getting restrictions on mortgage revenue bonds in late 1980. Today the housing industry is flat on its back and the Secretary of the Treasury is talking about returning to mortgage revenue bonds to stimulate housing.

With unemployment growing and bankruptcies by small companies spreading like wildfire, do we really want to hurriedly pass restrictions which may amount to the elimination of industrial revenue bonds? As the Congressional Budget Office predicted in its study:

> If the Congress eliminated the tax-exemption on small issue IRB's, some investments might not go forward * * * Smaller firms would be the ones most affected. Moreover investment in distressed urban areas might decline * * *.

Should we plunge ahead again to follow the Treasury's lead in the face of this prognosis?

Thank you.

Mr. RANGEL. Thank you, Mr. Patterson.

[The prepared statement follows:]

STATEMENT OF ROBERT E. PATTERSON, EXECUTIVE DIRECTOR, MASSACHUSETTS INDUSTRIAL FINANCE AGENCY

April 6, 1982 - Mr. Chairman and honorable members of the committee: In these recessionary times brought on by record interest rates, it seems incredible to me that the Treasury is trying to force through restrictions which would cripple industrial revenue bonds without thoughtfully considering the benefits this program has brought to small companies and state economic development efforts.

I believe that it is time to look at the facts about not only the true benefits of IRBs, but also the true costs of the program since this is allegedly a "revenue enhancement" proposal.

An economist at the University of Massachusetts has just completed an analysis of the economic impact of industrial revenue bonds in the state of Massachusetts. Please note that this study is based only on jobs that would not have resulted had industrial revenue bonds been unavailable to expanding employers.

The analysis shows that in the five years between 1983 and 1987, these jobs will result in:

* A total of $304 million of increased federal income tax

* $243 million of increased state taxes

and * An increase in personal income of $2.9 billion.

Over the next ten years, these new jobs will result in an additional $6.5 billion of personal income, and $1.29 billion of additional state and federal taxes.

This complements the Congressional Budget Office findings of last year that if IRBs were allowed to continue, they would generate over $4 billion additional Gross National Product and $2.2 billion in additional wages and salaries - enough to employ 150,000 workers at an annual salary of $15,000.

At a time when the Administration is trying to turn over costly federal programs to state government on one hand, it seems unfair that they should take away such an important tool on the other hand which serves to encourage the growth of small businesses and stimulates new jobs and state tax revenues - at little or no cost to the federal government.

It is also curious why the Treasury would stop a program which encourages economic growth at a time when our nation is in the midst of a terrible recession. We are faced with the highest real interest rates in our history, high unemployment, a high number of business failures, and low productivity. I would submit that now is not the time to end a program which provides affordable capital to growing smaller businesses.

By now everyone has heard the stories of K-Marts and MacDonalds. So when considering the Treasury's "reforms" which could cut off the only effective means of cutting interest rates on productive investments, it is wise to separate the rhetoric surrounding industrial revenue bonds from the facts.

The rhetoric suggests that IRBs assist primarily large national corporations. Yet the fact is that the CBO study on IRBs found that the bonds have been used overwhelmingly by smaller businesses. For example, in recent years over 90 percent of all IRBs were issued for closely held firms not listed on any regional or national stock exchange and therefore dependent on local financing. Only seven percent went to Fortune 1,000 companies, and only half of these issues exceeded $1 million.

In Massachusetts, three-fourths of the companies that have received bonds had sales under $20 million, and one-half had sales of less than $5 million. The majority of IRB recipients employ less than 100 employees in the state.

The rhetoric suggests that IRBs are inefficient and costly to the federal government and that the Treasury's restrictions are needed to "enhance" federal revenues. Yet the fact is that even the Treasury projects a net revenue decrease in 1983 if its proposals are enacted. Last year the Congressional Budget Office projected that if IRBs were eliminated, the government would raise only $200 million in 1982, rising slowly to $700 million in 1986.

Other studies including one completed at the University of Chicago for the Massachusetts-based Smaller Business Foundation of America, question the Treasury's assumptions and show that by stimulating private investment IRBs may actually increase the Treasury's funds.

The concept that IRBs stimulate investment and actually raise tax revenues is hardly a crackpot notion. In 1980 a leading "supply side" economist, Dr. Norman Ture, studied IRBs and concluded that:

> IRBs are productive instruments for promoting economic development by making saving and investment more attractive to individuals and businesses . . . The resulting expansion of tax bases -- individual, corporate and payroll taxes -- would generate net gains in tax revenues for the federal government and for the state and local governments of the issuing jurisdictions.

As you know, Dr. Ture today is the U.S. Treasury's undersecretary for tax policy.

The rhetoric suggests that IRBs are out of control with overly generous eligibility criteria. Yet the fact is that high interest rates have caused the increase in IRB financing in recent years, and that the "window of eligibility" has actually decreased dramatically as a result of inflation. Today the $10 million company limitation per jurisdiction really buys over a quarter less plant and equipment in real terms than the $5 million limit enacted in 1968. Again, as the CBO noted, and I quote, "The $10 million capital expenditure limit effectively keeps most large corporations from making much use of small issues."

In Massachusetts, we have seen the importance of lowering interest rates through industrial revenue bonds to stimulate investment and more jobs. projects financed with IRBs over the last three years promise to produce 47,000 new, permanent jobs and 18,000 man-years of construction work.

Do IRBs stimulate new investment? IRB recipients in Massachusetts were surveyed, and 85 percent responded that without the interest rate reduction afforded by IRBs they would have reduced or cancelled their plant expansions.

One-third of the companies said that they would have cancelled their expansion outright, another third would have delayed their growth, and one-fifth would have expanded less by an average of 42 percent.

The Treasury's Proposal

The main trouble with the Treasury proposal is that they are attempting to eliminate small issue IRBs by making them unattractive and useless to small companies. Once a project has been financed under the Treasury's restrictions, it would not be eligible for the accelerated depreciation schedules. In other words, a company using an IRB--the only reasonably priced expansion capital available to smaller companies--would never be able to depreciate that plant according to the 1981 Accelerated Cost Recovery Schedules.

Where I part company from the Treasury is that I accept the fact that the benefits of IRBs have gone overwhelmingly to small companies, and I believe that those firms deserve the financing assistance IRBs afford to offset the disadvantages that small companies operate under in the financial markets. The Treasury's proposals would take away the advantage offered by IRBs, and as a matter of policy I am opposed to that.

Far better, I suggest, to approach the issue of IRB reforms from the perspective of the abuses. The abuses have been in the unrestricted use of IRBs for commercial real estate developments. It would be far better to adopt the Massachusetts approach of targetting these projects, more along the lines of Congressman Rangel's bill which came out of the House Ways and Means Oversight Subcommittee hearings last year, although some adjustment to the criteria of "distressed areas" should be considered.

If Congress adopts the Treasury's proposals, however, there will be no benefit to smaller companies, and in the name of "reform" we will have lost IRBs for both our productive high-tech companies and our experienced developers willing to take on projects in our distressed areas.

Given what is happening to the budget, soon there will be no special assistance for distressed areas, and in a state like Massachusetts we cannot accept this result. I note that even the Treasury has agreed that industrial revenue bonds should be used to aid investment in distressed areas, although they want to limit this provision to "enterprise zones". Although the enterprise zone concept may offer promise, I suspect it will be far too narrowly defined to help many of the deserving distressed areas.

I urge Congress to carefully consider IRB reforms before passing them at a time of such incredible interest rates, growing unemployment, and fears of depression precipitated by high interest. I cannot help recalling the pressured atmosphere in which the Treasury succeeded in getting restrictions on mortgage revenue bonds in late 1980. Today the housing industry is flat on its back and the Secretary of the Treasury is talking about returning to mortgage revenue bonds to stimulate housing!

With unemployment growing and bankruptcies by small companies spreading like wildfire, do we really want to hurriedly pass restrictions which may amount to the elimination of industrial revenue bonds? As the Congressional Budget Office predicted in its study, "if the Congress eliminated the tax-exemption on small issue IRBs, some investments might not go forward....Smaller firms would be the ones most affected. Moreover investment in distressed urban areas might decline...."

Should we plunge ahead again to follow the Treasury's lead in the face of this prognosis?

Mr. **Rangel**. Next is the State treasurer, State of South Carolina, Grady Patterson.

STATE OF SOUTH CAROLINA, ON BEHALF OF THE NATIONAL ASSOCIATION OF STATE AUDITORS, COMPTROLLERS, AND TREASURERS

Mr. **Grady Patterson**. Mr. Chairman, and distinguished members of the committee, first I would like to express my appreciation for the opportunity to appear here this morning. I would ask that my statement be included in the official record of these proceedings.

Mr. **Rangel**. Without objection, Mr. Secretary.

Mr. **Grady Patterson**. I am appearing as chairman of the Tax-Exempt Committee of the National Association of State Auditors, Comptrollers, and Treasurers, and as the treasurer of the State of South Carolina.

I want to address my remarks with respect to the minimum tax. As you are aware, the administration has proposed certain tax features which would deny financial institutions' expense associated with their investment in State and municipal bonds.

I think it would be advantageous to us, Mr. Chairman, and gentlemen, to pause for a moment and look at the legal and constitutional basis for tax-exemption.

So many continue to ignore the legal basis for the tax exemption of State and municipal bonds. I think it is essential to restate the legal basis for the basis of tax exemption.

The Supreme Court of the United States has spoken to the issue on many occasions. In an early case, *Mercantile Bank* v. *City of New York,* 7 Supreme Court 826 (1887), in which it said:

> Bonds issued by the State of New York, or under its authority by its public municipal bodies, are means for carrying on the work of the government and are not taxable, even by the United States, and it is not a part of the policy of the government which issues them to subject them to taxation for its own purposes.

Some have argued that the 16th amendment included authority for the Congress to tax State and municipal bonds. The text of the 16th amendment to the U.S. Constitution is as follows:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any censu3 or enumeration.

The amendment became effective in 1913, but the record surrounding the passage of the 16th amendment clearly indicates there was no intent on the part of the Congress to tax State and municipal bonds. To the contrary, the record shows there was a clear intent not to include authority for the Federal Government to tax State and municipal securities.

There is enough in the record to clearly indicate that intent on behalf of the Congress. Thus the constitutional basis for tax exemption of interest earned on State and municipal bonds is expressed in a long line of Supreme Court decisions and is crystal clear. Moreover, the meaning and intent and purpose of the 16th amendment were not directed at tax exemption. The evil to be remedied by the 16th amendment was the adverse effect of the *Pollock* decision that went to the Supreme Court on two different occasions.

Beyond any doubt, the 16th amendment did not grant Congress any new authority or power to tax State and municipal bonds. The myth about what the 16th amendment meant with respect to municipal bonds should be dispelled and forever laid to rest.

With respect to the proposals which deal with the minimum tax that the administration has proposed for your consideration and the consideration of the Congress, the minimum tax proposal as it applies to the financial institutions has a single very simple and disastrous effect.

If this provision is enacted into law the tax-exempt bonds we have issued and are now outstanding will become taxable. Any future securities we issue will become taxable, for if a bond can be taxed in the hands of any investor, it is no longer a tax-exempt security.

The impact this will have on the market for State and local bonds cannot be determined with mathematical preciseness, but it will certainly be instantly severe. Yesterday I talked with several bankers in South Carolina and they tell me that just the mere threat of this type of legislation is already causing bankers to make other plans with respect to investing in State and municipal bonds.

So the mere threat has an adverse effect, and just think what the enactment of such legislation would have on the interests and the interest in purchasers of State and municipal bonds.

I think we should pause for a moment and consider the basic purpose of the tax-exempt status of State and municipal bonds in the first place. The bedrock of the exemption as I have indicated was and is the constitutional foundation of the separation of powers and the sovereignty of the several States. This exemption enables political entities to sell their securities at the lowest possible cost, thereby keeping to a minimum the cost to the taxpayers of the several States in these United States.

In order to do this the securities of necessity have to be priced so as to be salable and marketable. This arrangement has worked extremely well for decades and I see no valid reason for changing it. Any program to tax State and local bonds to the slightest degree raises the question of constitutionality which I am possible would be raised.

If this happened it would immediately cause chaos in the bond market and put all taxable issues under a cloud where they would remain during the long term, it would take the Supreme Court to decide the issue.

In conclusion, Mr. Chairman, and gentlemen, we respectfully urge this committee to reject all proposals that would alter, modify or destroy the tax-exempt status of State and municipal bonds. Thank you.

[The prepared statement follows:]

STATEMENT OF GRADY L. PATTERSON, JR., STATE TREASURER OF SOUTH CAROLINA

Mr. Chairman and Ladies and Gentlemen of the Committee: First, I want to express my appreciation to this Committee for an opportunity to be heard in opposition to suggestions of alternatives to the tax exempt status of state, municipal and political subdivision bonds.

I am appearing as Chairman of the Tax Exempt Committee of the National Association of State Auditors, Comptrollers and Treasurers and the State of South Carolina. We are grateful for an opportunity to express to you our profound opposition to these detrimental proposals.

The Administration has proposed certain tax features which would deny financial institutions expense associated with their investment in state and municipal bonds.

LEGAL AND CONSTITUTIONAL BASIS FOR TAX EXEMPTION

Because so many continue to ignore, either through oversight or design, the legal basis for the tax exemption of state and municipal bonds, I think it appropriate to set forth and restate the legal basis for the tax exemption of the interest earned on state and municipal bonds.

The Supreme Court of the United States has spoken to the issue on many occasions. In an early case, Mercantile Bank v. City of New York, 7 Sup. Ct. 826, (1887), in which it said:

> Bonds issued by the State of New York, or under its authority by its public municipal bodies, are means for carrying on the work of the government and are not taxable, even by the United States, and it is not a part of the policy of the government which issues them to subject them to taxation for its own purposes.

Some have argued that the 16th Amendment included authority for the Congress to tax state and municipal bonds.

The text of the 16th Amendment to the United States Constitution is as follows:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.

The Amendment became effective in 1913.

In perhaps the first decision of the United States Supreme Court taking cognizance of its ratification, Brushaber v. Union P. R. Co., 36 Sup. Ct. 236, (1915), Chief Justice White for a unanimous Court held:

> It is clear on the face of this text that it does not purport to confer power to levy income taxes in a generic sense,--an authority already possessed and never questioned,--or to limit and distinguish between one kind of income taxes and another, but that the whole purpose of the Amendment was to relieve all income taxes when imposed...from a consideration of the source when the income was derived.

The Chief Justice goes on to point out that the obvious intention of the Amendment was to do away with the principle upon which the case of Pollock v. Farmers' Loan & Trust Co., 15 Sup. Ct. 674, (1895), was decided.

The Pollock case was twice argued in the Supreme Court, and on the principal questions it was decided by a five to four majority. In substance, the majority held that despite the unquestioned right of Congress to levy taxes on income when such income tax was levied upon rents, it was judicially a direct tax upon the real estate from whence the rents were derived. Accordingly, since Congress was prohibited from levying direct taxes by the provisions of Article I, Section 2, Clause 3, unless they be apportioned among the states according to population, such tax was unconstitutional.

When one first reads the 16th Amendment and notes the language permitting the Congress to tax "income from whatever source derived," one's first impression would be that this was intended to permit Congress to tax income from municipal bonds. One has to read further to see that the significant portion of the Amendment is that which permitted this taxation without apportionment among the several states and without regard to any census or enumeration.

Pollock had held that the tax on rent from real property was, in effect, a tax upon the property itself. It was accordingly necessary in order to overcome Pollock to say in so many words that Congress might tax the income from real estate notwithstanding that it was a direct tax upon real estate. This, and this alone, was the thrust of the 16th Amendment, for it had been unanimously conceded that to tax the income on state bonds was, in effect, an act of taxation by Congress on the states themselves--something that could not be done without destroying the Federal System.

HISTORICAL BACKGROUND SURROUNDING THE BASIS OF THE SIXTEENTH AMENDMENT

The record surrounding the passage of the 16th Amendment reveals conclusively the intent not to include power or authority for the Federal Government to tax state or municipal securities.

In April 1910, Senator Norris Brown from Nebraska had this to say concerning the question "Shall the Income Tax Amendment be Ratified?":

> Recently, the question has been raised by those who are opposed to the ratification of the amendment that with the amendment ratified the powers of the States will in some way be impaired and their strength and vitality, in some way not specified, destroyed. The objection is not sound. The amendment in no way changes the existing relation between the State and the Federal Government. Whether the amendment is ratified or not, the rights of the State as a State and those of the Federal Government in their relation to each other will remain the same. Each sovereignty is now wholly independent of the other in the exercise of certain governmental functions, and the proposed amendment neither adds to nor takes away from the independence now enjoyed by each....

Earlier, Senator Joseph W. Bailey, Texas, made the following observation:

> I have also responded to the unanimous decision of the Supreme Court of the United States that Congress has no power to levy a tax upon the incomes derived from state, county and municipal securities, and I have specifically exempted them. I regarded it as unfortunate when the old act was passed that they were then included. I thought it certain, then, that the court would decide--and I think that the court ought to have decided--that part of the old act unconstitutional.

In the early days of the Republic that court, in a decision, announced by its most illustrious member, declared that States, counties and municipalities could not levy a tax upon Federal obligations holding that to permit it would be equivalent to a permission for the States to lay a tax upon the operations and instrumentalities of the Federal Government. I have always believed that decision wise and just; and if it is, then it necessarily follows that its reasoning applies equal force against a federal tax upon the operations or instrumentalities of the States and their subdivisions. But even if I doubted that, I would have conformed the amendment to what was the unanimous judgment of the court. (Congressional Report, Vol. 44, Part 2, 61st Congress, 1st Session.)

Senator Borah of Idaho is on record as follows: I say, therefore, that already Congress is given absolute power; and if the reasoning of the distinguished governor [Hughes, New York] were correct, the language being full and complete, conveying all power, we could tax state bonds and municipal securities and state salaries at the present time.

But there is another controlling reason why we cannot do so, which reason is omitted in the message and which is not affected by this amendment in any manner. The first time the question arose as to power of one sovereignty was in the case of McCulloch v. Maryland. In that case, as all lawyers well remember, there was an attempt on the part of the State of Maryland to tax the stock of the United States Bank. The United States Bank having been organized as an instrumentality of the National Government to carry out certain functions of granted power, it was held that it was not a taxable article. In that case, Chief Justice Marshall considered this question and gave us the basis upon which has been built the entire structure of law which prevents one nationality from taxing the instrumentalities and means of another.

In the first place, it was admitted by the Chief Justice that there was no provision of the Constitution which controlled the subject-matter. It was stated by the Chief Justice that there was neither any limitation nor grant of power which prevented the States from taxing the instrumentalities of the National Government, and he stated in his decision that, therefore, the taxing power of the National Government being complete, the inhibition had to be found somewhere other than that of the taxing clause itself. He said in McCulloch v. Maryland (4 Wheat.):

> There is no express provision [of the Constitution] for that case, but the claim--

That is, the exemption from taxation--

> has been sustained on a principle which so entirely pervades the Constitution, is so intermixed with the materials which compose it, so interwoven with its web, so blended with its texture as to be incapable of being separated from it without rending it to shreds. (Congressional Record, February 10, 1910, p. 1696.)

Thus, the Constitutional basis for tax exemption of interest earned on state and municipal bonds as expressed in a long line of U. S. Supreme Court decisions is crystal clear. Moreover, the meaning, intent and purpose of the 16th Amendment were not directed at tax exemption. The evil to be remedied by the 16th Amendment was the adverse effect of the Pollock decision. Beyond any doubt, it (16th Amendment) did not grant Congress any new authority or power to tax state and municipal bonds. The myth about what the 16th Amendment means with respect to state and municipal bonds should be dispelled and forever laid to rest.

MINIMUM TAX PUNITIVE IN NATURE

It is my opinion that the minimum tax provisions that now exist in the Federal Internal Revenue Code are unwarranted and clearly punitive in nature. They place additional burdens on certain taxpayers who already pay substantial sums of their earnings in income tax.

Why should some taxpayers go through the preparation of tax returns meeting all lawful requirements of all other taxpayers and end up not owing any tax, or a small amount of tax. Then the minimum tax feature comes into play and says that just because little or no tax is due, you must pay some tax, or more tax, anyway. This is clearly punitive and against Constitutional guarantees of due process and equal protection of the laws and all principles of democracy.

TAX EXEMPT STATUS DESTROYED BY MINIMUM TAX

The minimum tax proposal as it applies to the financial institutions has a single, very simple and disastrous effect. It destroys the tax exempt status of state, municipal and political subdivision bonds. If this provision is enacted into law, the tax exempt bonds we have issued and are now outstanding will become taxable, and any further securities we issue will be taxable. For if a bond can be taxed in the hands of any investor, it is no longer a tax exempt security. The impact this will have on the market for state and local bonds cannot be determined with mathematical preciseness, but it will certainly be instantly severe.

BASIC PURPOSE OF TAX EXEMPT STATUS

I think we should pause for a moment and consider the basic purpose of the tax exempt status of state and municipal bonds in the first place. The bedrock of the exemption was and is the

Constitutional foundation of the separation of powers and sovereignty of the several states. This exemption enables political entities to sell these securities at the lowest possible cost, thereby keeping to a minimum the cost to the taxpayers. In order to do this, these securities of necessity had to be attractively priced so as to be saleable and marketable. This arrangement has worked extremely well for decades, and I see no valid reason for changing it.

Any program adopted to make state and local bonds taxable, even in the slightest degree, immediately raises the question of constitutionality, which I am positive would be raised. If this happened, it would immediately cause chaos in the bond market and put all taxable issues under a cloud where they would remain during the long time that it would take the Supreme Court to decide the issue.

CONCLUSION

We respectfully urge this Committee to reject all proposals which would alter, modify or destroy the tax exempt status of state and municipal bonds.

Respectfully submitted,

Mr. ROUSSELOT. Thank you, Mr. Secretary.
Mr. White.

STATEMENT OF THOMAS W. WHITE, EXECUTIVE VICE PRESIDENT, COUNCIL OF STATE HOUSING AGENCIES

Mr. WHITE. Thank you, Mr. Chairman, members of the committee.

My name is Tom White. I am executive vice president of the Council of State Housing Agencies. CSHA represents the 52 State-authorized housing finance agencies in 46 States, the city of New York, Washington, D.C., and Puerto Rico.

I sit here having gone through the Mortgage Subsidy Bond Act of 1980 which State and local financial agencies are still in the process of adjusting to. In fact, the Treasury has yet to issue regulations for rental projects under the 1980 act.

Although this is not the time, I suggest that it would be appropriate to reopen the issue of housing bonds to assess the impacts of the Ullman bill and determine if congressional intent has been met.

My testimony today will focus on the rental housing impacts of the administration's industrial development bond proposal. In 1980, Congress targeted the use of multifamily bonds providing that 20 percent of the units must be for low income, also providing that the bonds must be in registered form.

However, in recognition of the critical public purpose played by multifamily bonds, particularly in implementation of Federal programs, Congress exempted them from the December 1983 Sunset that applied to single family issue and moreover, because of the cost and risk associated with low- and moderate-income rental housing, Congress exempted multifamily bonds from the arbitrage and reserve fund restrictions that applied to single family issues.

The key point is that 16 months ago Congress completed lengthy deliberations on housing bonds and produced legislation to insure their targeted and efficient use. There have been major problems with the Act, not the least of which is virtual preclusion of self-supporting single family bond sales. Rather than starting from scratch, CHSA strongly recommends that Congress exclude rental housing from the administration's proposal. The main purpose for the administration's IDB proposal, as I understand it, is to curb rapid growth of nontargeted use of small issue IDB's. The problems with these IDB's simply doesn't apply to rental housing bonds. There is a significant error in the administration's explanation of its IDB proposal.

The administration charted the growth of housing bonds between 1976 and 1981. Although the proposal does not apply to single family mortgage revenue bonds, single family bonds were included in the annual totals. Growth in rental housing bonds over the last 5 years has been less than 54 percent compared with 700 percent for small issuer IDB's.

In fact, rental housing volume has dropped steadily since 1979, the year of the highest section 8 housing subsidy production program. All the totals from 1976 and onward, follow closely the production levels under either the section 8 program or its predecessor, the 236 program.

Combining State HFA and local bond financing via the 11-B program accounts for the vast majority of multifamily rental housing bond issues during the last 6 years. If the purpose of the administration proposal is to curb runaway growth in IDB volume, such measures are unnecessary for rental housing bonds because market forces relating to rental housing development and cutbacks in Federal production assistance programs already serve that purpose.

The most damaging aspect of the administration IDB proposal is the prohibition of accelerated depreciation for bond-financed rental housing. The plain truth is that to motivate investors to assume the risk and costs of even moderate-income rental housing development—80 percent to 120 percent of median income—neither accelerated depreciation nor IDB financing alone will be sufficient to result in annual production much over several thousand units per year nationwide. With rapid depreciation, unsubsidized rental housing starts nevertheless have been declining since 1977.

Even HUD acknowledges that, without the tax benefits, the present fee structure for section 8 will be insufficient to prompt development of these units.

Through the syndication process, developers of rental housing are able to turn a portion of the tax benefits into equity. This equity is necessary to reduce financing costs and insure the long-term viability of the project.

If accelerated depreciation is disallowed, syndication will not be possible. Without syndication equity, developers of moderate cost rental units will have to come up with an additional sum of $6,000 to $8,000 per unit. If it were possible to offset this loss by increasing the loan-to-value ratio on the mortgage, rents would have to increase substantially.

This is really an academic exercise since it would be impossible to obtain permanent financing for a unit with a loan-to-value ratio of 95 percent or more, and no developer would assume the risks of moderate-income rental housing development where his cash flow is completely consumed by debt service and he is committed to hold units aside for low income for 20 years.

Eliminating Federal supports for low- and moderate-income housing production and severely restricting State and local access to tax exempt rental housing bonds will cut national rental housing production in half and virtually eliminate all low- and moderate-income rental housing production. Such financing simply is not possible given high interest rates in the conventional market.

Beside the fact that few nonluxury conventional apartments are being built, annual losses to the rental stock due to condominium conversion, abandonment, and demolition are having a devastating effect on rental housing supply. George Strenlieb of Rutgers University estimates that demolition and abandonment losses to the existing rental stock will average 578,000 units annually during the eighties.

Estimates of increases in need resulting from household formation range up to 400,000 units per year throughout the eighties. When losses to the existing stock are added to household-formation-related statistics we see—as a minimum—that an annual rental production requirement of 600,000 units per year is needed to maintain the current rental supply. Advance mortgage corporation reports that in 1981, conventional unsubsidized apartment starts were slightly over 100,000 units—at all prices ranges. With the Federal Government backing out of low-income rental housing production and if these proposals to strangle rental housing bonds are passed, how will the critical need for low- and moderate-income rental housing production be met?

In conclusion, Congress, following lengthy examination of the issue, recently passed comprehensive housing bond legislation in the Mortgage Subsidy Bond Tax Act. The shock waves that the 1980 act sent through State and local government are still being felt.

The Senate recently has passed legislation to remove a number of the most impractical aspects of the 1980 act. Taking up new, and far more restrictive housing bond legislation is premature and clearly unjustified given the great need for rental housing and the declining role of the Federal Government in low- and moderate-income rental housing production.

The Council of State Housing Agencies strongly recommends that Congress strike all reference to rental housing bonds in this legislative proposal.

I would be happy to answer any questions at this time.

[The prepared statement follows:]

STATEMENT OF THOMAS W. WHITE, EXECUTIVE VICE-PRESIDENT, THE COUNCIL OF STATE HOUSING AGENCIES

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, MY NAME IS TOM WHITE. I AM EXECUTIVE VICE PRESIDENT OF THE COUNCIL OF STATE HOUSING AGENCIES. CSHA REPRESENTS THE 52 STATE-AUTHORIZED HOUSING FINANCE AGENCIES IN 46 STATES, THE CITY OF NEW YORK, WASHINGTON, D.C. AND PUERTO RICO. PRIOR TO JOINING CSHA, I WAS DIRECTOR OF THE OFFICE OF STATE AGENCIES AND BOND-FINANCED PROGRAMS AT HUD. BEFORE THEN, I WAS THE DIRECTOR OF DEVELOPMENT FOR THE MICHIGAN STATE HOUSING DEVELOPMENT AUTHORITY.

TODAY, STATE HOUSING FINANCE AGENCIES ARE STILL ADJUSTING TO THE MULTIFAMILY HOUSING PROVISIONS OF THE MORTGAGE SUBSIDY BOND TAX ACT. THE TREASURY HAS YET TO ISSUE REGULATIONS FOR RENTAL PROJECTS UNDER THE 1980 ACT. ALTHOUGH THIS IS NOT THE TIME, I SUGGEST THAT IT WOULD BE APPROPRIATE TO REOPEN THE ISSUE OF HOUSING BONDS TO ASSESS THE IMPACTS OF THE ULLMAN BILL AND DETERMINE IF CONGRESSIONAL INTENT HAS BEEN MET.

MY TESTIMONY TODAY WILL FOCUS ON THE RENTAL HOUSING IMPACTS OF THE ADMINISTRATION'S INDUSTRIAL DEVELOPMENT BOND PROPOSAL. IT IS VERY IMPORTANT TO STRESS THAT, IN ITS PRESENT FORM, THE ADMINISTRATION PROPOSAL DOES APPLY TO RENTAL HOUSING BONDS. LET ME FIRST BRIEFLY OVERVIEW THE FOUR SECTIONS OF THE PROPOSAL THAT WILL AFFECT LOW AND MODERATE INCOME RENTAL HOUSING DEVELOPMENT:

- ALL RENTAL HOUSING BOND ISSUES ARE TO BE SUBJECT TO PUBLIC REVIEW AND APPROVAL BY ELECTED REPRESENTATIVES OF STATE OR LOCAL GOVERNMENT;

- AFTER 1985, STATE OR LOCAL GOVERNMENT MUST PROVIDE FOR THE RENTAL DEVELOPMENT AN IN-KIND CONTRIBUTION WITH A PRESENT VALUE EQUAL TO 1% OF THE BOND ISSUE;

- AGENCIES WILL NOT BE ALLOWED TO EARN ARBITRAGE ON THE INTERIM INVESTMENT OF BOND PROCEEDS OR ON THE INVESTMENT OF RESERVE FUND CAPITAL. BOND UNDERWRITER DISCOUNTS AND BOND COUNSEL FEES CANNOT BE APPLIED TO CALCULATIONS FOR ARBITRAGE LIMITATION PURPOSES; AND

- RENTAL HOUSING DEVELOPMENTS FINANCED WITH TAX EXEMPT BONDS CANNOT BENEFIT FROM THE DEPRECIATION PROVISIONS IN THE ACCELERATED COST RECOVERY SYSTEM IMPLEMENTED UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981.

ALL OF THESE PROPOSALS SIGNIFICANTLY INCREASE THE DEGREE OF FEDERAL REGULATION OVER RENTAL HOUSING BOND ISSUES. THE PUBLIC REVIEW REQUIREMENT WILL JEOPARDIZE THE TIMING OF BOND SALES AND MAY ALLOW SMALL COMMUNITY FACTIONS TO DELAY PROJECT CONSTRUCTION DUE TO OBJECTIONS OVER PROJECT SITING. PRESENTLY, ALL STATE HFA BOND ISSUES ARE SUBJECT TO REVIEW AND APPROVAL BY BOARDS APPOINTED BY STATE GOVERNORS AND LEGISLATURES.

REQUIRING AN IN-KIND CONTRIBUTION FROM STATE GOVERNMENT MAY BE WORKABLE IN SOME CASES. HOWEVER, A PROVISION OF THIS KIND CLEARLY DISCRIMINATES AGAINST LESS AFFLUENT STATES—THE VERY SAME STATES THAT MAY BE MOST IN NEED OF LOW AND MODERATE INCOME RENTAL HOUSING.

THE ARBITRAGE AND RESERVE FUND SECTIONS OF THE PROPOSAL WILL WEAKEN THE SECURITY OF LOW AND MODERATE INCOME RENTAL PROJECTS. A SIMILAR PROPOSAL WAS REJECTED BY CONGRESS IN THE MORTGAGE SUBSIDY BOND TAX ACT. IF PASSED INTO LAW, THESE RESTRICTIONS WOULD ELIMINATE THE ABILITY OF ISSUING AGENCIES TO DEVELOP THE CASH RESERVES NECESSARY TO ENSURE THE LONG-TERM VIABILITY OF RENTAL PROJECTS.

EXCLUDING BOND-FINANCED RENTAL HOUSING FROM THE ACCELERATED DEPRECIATION PROVISIONS OF THE ECONOMIC RECOVERY TAX ACT WILL EFFECTIVELY RESTRICT LOW AND MODERATE INCOME RENTAL HOUSING INVESTMENT TO A SMALL NUMBER OF NONPROFIT CORPORATIONS. INVESTOR OWNERS WILL NOT BUILD LOW AND MODERATE INCOME RENTAL HOUSING BECAUSE THE OPPORTUNITIES FOR APPRECIATION WILL, IN MOST CASES, NOT OFFSET THE COSTS AND RISKS.

RENTAL HOUSING INVESTMENT SYNDICATES WILL BE RULED OUT ENTIRELY. MANY NON-PROFIT GROUPS RELY ON THE SYNDICATION PROCESS TO RAISE CAPITAL FOR HOUSING SERVICES, RESERVE FUNDS AND TO LOWER RENTS. MORE THAN ANY OTHER PROVISION OF THE ADMINISTRATION PROPOSAL, THE EXCLUSION OF BOND-FINANCED PROPERTIES FROM ACCELERATED DEPRECIATION WILL KILL INVESTMENT IN LOW AND MODERATE INCOME RENTAL HOUSING.

THESE MEASURES, IN TANDEM WITH THE RESTRICTIONS ALREADY IMPLEMENTED UNDER THE MORTGAGE SUBSIDY BOND TAX ACT, WILL MAKE IT EXTREMELY DIFFICULT FOR STATE AND LOCAL GOVERNMENT TO ISSUE RENTAL HOUSING BONDS. WHERE BOND ISSUES ARE WORKABLE, THE PROHIBITION REGARDING ACCELERATED DEPRECIATION WILL PRECLUDE ANY PRIVATE INVESTMENT IN LOW AND MODERATE INCOME RENTAL HOUSING.

THE ADMINISTRATION'S PROPOSAL DUPLICATES IN GENERAL INTENT AND IN MANY OF ITS SPECIFIC PROVISIONS, THE MORTGAGE SUBSIDY BOND TAX ACT.

FOLLOWING TWO YEARS OF STUDY AND DEBATE, CONGRESS PASSED THE MORTGAGE SUBSIDY BOND TAX ACT OF 1980. AS AN OUTCOME OF THAT LAW, ALL RENTAL HOUSING BONDS ISSUES SINCE JANUARY 1, 1982 MUST BE IN REGISTERED FORM (A PROVISION ALSO INCLUDED IN THE ADMINISTRATION PROPOSAL). THE 1980 ACT ALSO STIPULATES THAT, IN BOND-FINANCED RENTAL PROJECTS, AT LEAST 20% OF THE UNITS MUST BE RESERVED FOR LOW INCOME HOUSEHOLDS (A MORE SPECIFIC TARGETING PROVISION THAN WHAT IS INCLUDED IN THE ADMINISTRATION PROPOSAL).

IN RECOGNITION OF THE CRITICAL PUBLIC PURPOSE PLAYED BY MULTIFAMILY BONDS, PARTICULARLY IN THE IMPLEMENTATION OF FEDERAL HOUSING PRODUCTION PROGRAMS, CONGRESS EXEMPTED THEM FROM THE 1984 SUNSET THAT WAS APPLIED TO SINGLE FAMILY BONDS. MOREOVER, BECAUSE OF

THE COSTS AND RISKS ASSOCIATED WITH LOW AND MODERATE INCOME RENTAL HOUSING DEVELOPMENT, CONGRESS EXEMPTED MULTIFAMILY BONDS FROM THE STRICT ARBITRAGE AND RESERVE FUND RESTRICTIONS THAT WERE APPLIED TO SINGLE FAMILY ISSUES.

THE KEY POINT IS THAT, 16 MONTHS AGO, CONGRESS COMPLETED LENGTHY DELIBERATIONS ON HOUSING BONDS AND PRODUCED LEGISLATION TO ENSURE THEIR TARGETED AND EFFICIENT USE. THERE HAVE BEEN MAJOR PROBLEMS WITH THE MORTGAGE SUBSIDY BOND TAX ACT, NOT THE LEAST OF WHICH IS THE VIRTUAL PRECLUSION OF SELF-SUPPORTING SINGLE FAMILY BOND SALES.

RATHER THAN STARTING FROM SCRATCH ON AN ENTIRELY NEW PIECE OF HOUSING BOND LEGISLATION, CSHA STRONGLY RECOMMENDS THAT CONGRESS MAKE THE NEEDED "FINE-TUNING" ADJUSTMENTS TO THE 1980 ACT AND EXCLUDE RENTAL HOUSING BONDS FROM THE ADMINSTRATION PROPOSAL.

THE MAIN PURPOSE FOR THE ADMINISTRATION'S IDB PROPOSAL, AS I UNDERSTAND IT, IS TO CURB THE RAPID GROWTH AND NON-TARGETED USE OF SMALL ISSUE IDBS. THE PROBLEMS WITH SMALL ISSUE IDBS SIMPLY DON'T APPLY TO RENTAL HOUSING BONDS.

THERE IS A SIGNIFICANT ERROR IN THE ADMINISTRATION'S EXPLANATION OF ITS IDB PROPOSAL* ON PAGE 25, THE ADMINSTRATION CHARTS THE GROWTH OF "HOUSING" BONDS BETWEEN 1976 AND 1981. ALTHOUGH THE PROPOSAL DOES

---

*"GENERAL AND TECHNICAL EXPLANATIONS OF TAX REVISIONS AND IMPROVED COLLECTION AND ENFORCEMENT PROPOSALS," DEPARTMENT OF THE TREASURY, FEBRUARY 26, 1982).

NOT APPLY TO SINGLE FAMILY MORTGAGE REVENUE BONDS, SINGLE FAMILY BONDS WERE INCLUDED IN THE ANNUAL TOTALS. GROWTH IN RENTAL HOUSING BONDS OVER THE LAST FIVE YEARS HAS BEEN LESS THAN 54% COMPARED WITH 700% FOR SMALL ISSUE IDBS. IN FACT, RENTAL BOND VOLUME HAS BEEN DROPPING STEADILY SINCE 1979. THESE ANNUAL TOTALS CLOSELY FOLLOW PRODUCTION LEVELS UNDER THE SECTION 8 PROGRAM. FULLY ONE-THIRD OF ALL SECTION 8 UNITS HAVE BEEN FINANCED BY STATE HOUSING FINANCE AGENCIES WITH BONDS. COMBINING STATE HFA AND LOCAL BOND FINANCING VIA THE 11-B PROGRAM ACCOUNTS FOR THE VAST MAJORITY OF MULTIFAMILY RENTAL HOUSING BOND ISSUES DURING THE LAST SIX YEARS. IF THE PURPOSE OF THE ADMINISTRATION PROPOSAL IS TO CURB RUNAWAY GROWTH IN IDB VOLUME, SUCH MEASURES ARE UNNECESSARY FOR RENTAL HOUSING BONDS BECAUSE MARKET FORCES RELATING TO RENTAL HOUSING DEVELOPMENT AND CUTBACKS IN FEDERAL PRODUCTION ASSISTANCE PROGRAMS ALREADY SERVE THAT PURPOSE.

SMALL ISSUE IDB AND RENTAL HOUSING BOND GROWTH 1976-1981*

($ MILLIONS)

	1981	1980	1979	1978	1977	1976
SMALL ISSUE IDBS	10.5	8.4	7.1	3.5	2.3	1.5
RENTAL BONDS	3.7	4.1	5.6	3.7	2.3	2.4

---

*STATISTICS FROM DAILY BOND BUYER AND CONGRESSIONAL BUDGET OFFICE.

THE MOST DAMAGING ASPECT OF THE ADMINISTRATION IDB PROPOSAL IS THE PROHIBITION OF ACCELERATED DEPRECIATION FOR BOND-FINANCED RENTAL HOUSING. THE PLAIN TRUTH IS THAT TO MOTIVATE INVESTORS TO ASSUME THE RISK AND COSTS OF EVEN MODERATE INCOME RENTAL HOUSING DEVELOPMENT (80% TO 120% OF MEDIAN INCOME) NEITHER ACCELERATED DEPRECIATION NOR IDB FINANCING ALONE WILL BE SUFFICIENT TO RESULT IN ANNUAL PRODUCTION MUCH OVER SEVERAL THOUSAND UNITS PER YEAR NATION-WIDE. WITH RAPID DEPRECIATION, UNSUBSIDIZED RENTAL HOUSING STARTS NEVERTHELESS HAVE BEEN DECLINING SINCE 1977.

HUD EVEN ACKNOWLEDGES THAT, WITHOUT THE TAX BENEFITS, THE PRESENT FEE STRUCTURE FOR SECTION 8 WILL BE INSUFFICIENT TO PROMPT DEVELOPMENT OF THESE UNITS.*

THROUGH THE SYNDICATION PROCESS, DEVELOPERS OF RENTAL HOUSING ARE ABLE TO TURN A PORTION OF THE TAX BENEFITS INTO EQUITY. THIS EQUITY IS NECESSARY TO REDUCE FINANCING COSTS AND ENSURE THE LONG-TERM VIABILITY OF THE PROJECT.

IF ACCLERATED DEPRECIATION IS DISALLOWED, SYNDICATION WILL NOT BE POSSIBLE. WITHOUT SYNDICATION EQUITY, DEVELOPERS OF MODERATE COST RENTAL UNITS WILL HAVE TO COME UP WITH AN ADDITIONAL SUM OF $6,000 TO $8,000 PER UNIT. IF IT WERE POSSIBLE TO OFFSET THIS LOSS BY INCREASING THE LOAN TO VALUE RATIO ON THE MORTGAGE, RENTS WOULD HAVE TO INCREASE

---

*HUD ECONOMIC ANALYSIS DIVISION, "THE TAX SHELTER COST OF A SECTION 8 PRCJECT", APRIL 13, 1981.

SUBSTANTIALLY. THIS IS REALLY AN ACADEMIC EXERCISE SINCE IT WOULD BE IMPOSSIBLE TO OBTAIN PERMANENT FINANCING FOR A UNIT WITH AN LTV OF 95% OR MORE AND NO DEVELOPER WOULD ASSUME THE RISKS OF MODERATE INCOME RENTAL HOUSING DEVELOPMENT WHERE HIS CASH FLOW IS COMPLETELY CONSUMED BY DEBT SERVICE AND HE IS COMMITTED TO HOLD UNITS ASIDE FOR LOW INCOME FOR TWENTY YEARS.

ELIMINATING FEDERAL SUPPORTS FOR LOW AND MODERATE INCOME HOUSING PRODUCTION AND SEVERELY RESTRICTING STATE AND LOCAL ACCESS TO TAX EXEMPT RENTAL HOUSING BONDS WILL CUT NATIONAL RENTAL HOUSING PRODUCTION IN HALF AND VIRTUALLY ELIMINATE ALL LOW AND MODERATE INCOME RENTAL HOUSING PRODUCTION.

THE REASON UNSUBSIDIZED RENTAL HOUSING IS NOT BEING BUILT IN ANY QUANTITY IS THAT HOUSEHOLDS WHO CAN AFFORD THE RENTS REQUIRED BY NEW RENTAL UNITS MORE OFTEN THAN NOT CAN AFFORD TO BUY A HOME. AS A RESULT, HOWEOWNERSHIP HAS "CREAMED OFF" THE HGHER INCOME RENTERS AND LEFT A RENTER POPULATION UNABLE TO AFFORD NEWLY BUILT UNITS.

BESIDE THE FACT THAT FEW NON-LUXURY COVNENTIONAL APARTMENTS ARE BEING BUILT, ANNUAL LOSSES TO THE RENTAL STOCK DUE TO CONDOMINIUM CONVERSION, ABANDONMENT AND DEMOLITION ARE HAVING A DEVASTATING EFFECT ON RENTAL HOUSING SUPPLY. GEORGE STERNLIEB OF RUTGERS UNIVERSITY ESTIMATES THAT DEMOLITION AND ABANDONMENT LOSSES TO THE EXISTING RENTAL STOCK WILL AVERAGE 578,000 UNITS ANNUALLY DURING THE EIGHTIES.

ESTIMATES OF INCREASES IN RENTAL NEED RESULTING FROM HOUSEHOLD FORMATION RANGE FROM 290,000 TO 400,000 UNITS PER YEAR THROUGHOUT THE EIGHTIES. WHEN LOSSES TO THE EXISTING STOCK ARE ADDED TO HOUSEHOLD-FORMATION-RELATED STATISTICS WE SEE—AS A MINIMUM—THAT AN ANNUAL

RENTAL PRODUCTION REQUIREMENT OF 600,000 UNITS PER YEAR IS NEEDED TO MAINTAIN THE CURRENT RENTAL SUPPLY. ADVANCE MORTGAGE CORPORATION REPORTS THAT IN 1981, CONVENTIONAL UNSUBSIDIZED APARTMENT STARTS WERE SLIGHTLY OVER 100,000 UNITS—AT ALL PRICE RANGES. WITH THE FEDERAL GOVERNMENT BACKING OUT OF LOW INCOME RENTAL HOUSING PRODUCTION AND IF THESE PROPOSALS TO STRANGLE RENTAL HOUSING BONDS ARE PASSED, HOW WILL THE CRTICAL NEED FOR LOW AND MODERATE INCOME RENTAL HOUSING PRODUCTION BE MET?

CONCLUSION

conclusion CONGRESS, FOLLOWING LENGTHY EXAMINATION OF THE ISSUE, RECENTLY PASSED COMPREHENSIVE HOUSING BOND LEGISLATION IN THE MORTGAGE SUBSIDY BOND TAX ACT. THE SHOCK WAVES THAT THE 1980 ACT SENT THROUGH STATE AND LOCAL GOVERNMENT ARE STILL BEING FELT.

THE SENATE RECENTLY HAS PASSED LEGISLATION TO REMOVE A NUMBER OF THE MOST IMPRACTICAL ASPECTS OF THE 1980 ACT. TAKING UP NEW, AND FAR MORE RESTRICTIVE HOUSING BOND LEGISLATION IS PREMATURE AND CLEARLY UNJUSTIFIED GIVEN THE GREAT NEED FOR RENTAL HOUSING AND THE DECLINING ROLE OF THE FEDERAL GOVERNMENT IN LOW AND MODERATE INCOME RENTAL HOUSING PRODUCTION.

THE COUNCIL OF STATE HOUSING AGENCIES STRONGLY RECOMMENDS THAT CONGRESS STRIKE ALL REFERENCE TO RENTAL HOUSING BONDS IN THIS LEGISLATIVE PROPOSAL.

I WOULD BE HAPPY TO ANSWER QUESTIONS AT THIS TIME.

Mr. Rangel. I want to thank the entire panel, and those who have been through this route before, supporting and explaining their views on IDB's. Are there any questions from members of the committee? Mr. Anthony.

Mr. Anthony. Thank you, Mr. Chairman. Unfortunately we have got too many good witnesses on one panel to really be able to get into all the questions. But, Mr. Beatty, I have some questions I would like to ask.

On page 2 of your testimony, I guess page 1 after the cover sheet, you are talking about the municipal bond market. Taken all together the combination of significant cutbacks in Federal grant-in-aid funds to State and local government, then the unintended effects of the Federal tax law enacted last year and monetary policies of the Federal Reserve Board have presented a triple whammy for State and local government finances.

Then you got through areas where you analyze the Tax Code of 1981. My question is this: On page 2, do you recommend to the Congress that we eliminate the indexing of marginal tax brackets commencing in 1985?

Mr. Beatty. No, sir, we don't recommend that.

Mr. Anthony. You don't recommend we eliminate it, but you acknowledge that it is causing you problems?

Mr. Beatty. That is right.

Mr. Anthony. OK. Do you recommend to the Congress that we eliminate the creation of all-savers certificates?

Mr. Beatty. Yes, sir, we do have a policy that recommends it not be renewed in any form.

Mr. Anthony. What about reducing or going back on the marginal income tax, we reduced it from 70 to 50. Do you want to go back to 70?

Mr. Beatty. No, sir.

Mr. Anthony. Do you want to up the capital gains from 20 back——

Mr. Beatty. No, sir.

Mr. Anthony. How come you put it in your testimony?

Mr. Beatty. We tried to point out that it is more advantageous for the taxpayer now to shelter his income because he will not have to pay taxes and, basically, this has had very dire effects on the purchase of municipal bonds by the individuals of the household sector.

Mr. Anthony. In other words you are saying we screw your nest up, but you don't want us to unscrew it up. On page 3 you talk about expansion of leasing tax shelters. Do you want the Congress to modify or repeal the so-called safe harbor leasing provisions?

Mr. Beatty. We do not have a policy on that. However, we think the Congress should definitely take a look and see if that is detrimental to our interests.

Mr. Anthony. Further on, you talk about the increased pressure on the governments to borrow funds. As I understand the new numbers, they show about a $187 billion deficit for 1983, 220 and then 240. Are you suggesting the Federal Government do something in 1982 as far as trying to lower the Federal deficit staring us in the face?

Mr. BEATTY. Absolutely. We think all governments should try to keep deficits to a minimum.

Mr. ANTHONY. You think that would totally have about as much improvement in your municipal bond financing as any one single thing?

Mr. BEATTY. I think most economists have suggested that reduction of the debt of the Federal Government, and the defeats projected in the Federal budgets, would have a significant impact on the economy in general and all markets would then improve.

Mr. ANTHONY. Mr. Robert Patterson, I think on page 2 you really summarize what I personally think are some of the strong problems we have here. You are just saying at a time when the administration is turning over costly Federal programs to the State government which means they will have to raise taxes to finance them, at the same time they are trying to take away a tool that encourages growth of small business and stimulating jobs, and therefore, State tax revenues, it seems to be a contradictory position, doesn't it?

Mr. ROBERT PATTERSON. The Federal Government, the Treasury's position you mean? Yes.

Mr. ANTHONY. Yes. On page 3 you talk about economist Dr. Norman Tier talking in 1980 about how great IRB's were. Are you saying he has now changed his position?

Mr. ROBERT PATTERSON. I do not know what his current position is. But I do know the position of the U.S. Treasury.

Mr. ANTHONY. So if he is part of the Treasury and the Treasury has come forward with a position in opposition to him, you could safely say he has changed his position?

Mr. ROBERT PATTERSON. Maybe he is not making the position. I do not know what is going on over there.

Mr. ANTHONY. At least he has acceded to the party line?

Mr. ROBERT PATTERSON. The Treasury position does not seem to be the same he had in 1980.

Mr. ANTHONY. That is the problem, Mr. Chairman. I have too many good witnesses and too little time. There is excellent testimony here and a lot of good points. One final question. You have the National League of Cities, and you have everybody else that has testified for them and you are in opposition to them because of the conflict it creates, is there any middle ground there you could recommend to the committee?

Mr. GUTHMAN. Congressman, I don't believe we are in opposition. You will note in my prepared testimony we are saying the use of IDB's for private purposes has crowded out much traditional tax-exempt financing for governments to build infrastructure. We believe some of the provisions called for in the administration's proposal will help eliminate some of that crowding out, such as the public hearing requirement, for example.

If a public body is going to declare that an IRB serves a public purpose, then let that group of elected officials who have been put there by the public determine whether or not it is a public purpose. Let it be in the open. We do not believe a private company should have the benefit of both the tax-exempt financing and ACRS. Let them choose between the two. After all, ACRS was not there 2 years ago. How much should the taxpayer have to subsidize the private sector at the same time suffering from the high interest rates to carry on the public's business?

Mr. ANTHONY. That is good. One final question, or maybe a request. If this committee works very hard to try to work through your problems as proposed by the administration, would you assist this committee and this Congress in working through our problems in trying to reach an accord with the administration in trying to lower the deficit as we look at all the expenditures, including defense and other revenue raising measures it would take to drive this deficit number down?

Mr. GUTHMAN. Our policy, Mr. Anthony, states that we wish to lower the deficit. I am sure to the extent we can, within our policy, we will work with you.

Mr. ANTHONY. If you are not willing to go out and fight the large battles why should we sit here and fight the little battles?

Mr. GUTHMAN. I think we are.

Mr. ANTHONY. But you are not willing to take a position that says what you are willing to do specifically. It seems to me you are just hedging. As a matter of fact, it seems every witness who has come before the committee in the last 2 weeks when asked the hard, specific question, hedges.

Mr. GUTHMAN. We have gone on record as opposing the high Defense budget, for example. I would say that this is one of the big battles. We have taken specific positions on the budget issues.

Mr. ANTHONY. Well, I understand sometimes you can't do it through your association because of the structure, but you certainly have an individual voice and the membership of your association down to the grassroots also has an individual voice. If the growing deficit is a problem to you, I am just saying time is running out. You ought to get the word out either officially or unofficially and try to reach an accord.

Mr. GUTHMAN. I thought we had.

Mr. ANTHONY. Thank you, I congratulate you. I thought it was very excellent testimony. I am sorry we didn't have more time to get to each of you individually.

Thank you, Mr. Chairman.

Mr. RANGEL. Mr. Guarini.

Mr. GUARINI. No questions.

Mr. RANGEL. Mr. Shannon?

Mr. SHANNON. Thank you, Mr. Chairman. I want to commend all the witnesses for your very succinct testimony. I would like to address some questions to Mr. Robert Patterson from Massachusetts Industrial Finance Agency.

Mr. Patterson, let me just first of all welcome you and tell you that, both in Massachusetts and in Washington, I think you are a credit to the State government in Massachusetts and have a reputation for running a very efficient agency.

Mr. ROBERT PATTERSON. Thank you.

Mr. SHANNON. Your testimony touches greatly on the targeting aspects of industrial revenue bonds. Is there anything in the Massachusetts program which I think a lot of people view as a kind of model, which would prevent an industrial revenue bond from being used to relocate a firm from a lower income area to a higher income area?

Mr. Robert Patterson. No, there isn't. And in fact, we have moved a lot of companies that were formerly in multitiered space, in cities as you know, Congressman, your city begin a major example, they have relatively small boundaries. They are moving to single level modern, efficient space. They very rarely move out of their labor market area, however.

Notwithstanding that, over half of our projects have been in the cities of Massachusetts.

Mr. Shannon. I ask the question because a firm just moved out of my hometown to a much higher income area and took 400 jobs with it. I think it is going to end up with the people who had previously been working for them in my hometown being unemployed and those jobs going to somebody else.

Would it be wise for us in consideration of this broad issue to put a restriction on the issuance of industrial revenue bonds so they cannot be used for that purpose?

Mr. Robert Patterson. Well, as you know, Congressman Rangel's bill does say that industrial revenue bonds would not be eligible for interstate moves, and I think that is a policy that should be seriously considered. I would have considerable qualms within a State such as Massachusetts, having such a policy moving between jurisdictions because I am not familiar exactly with which company you are referring, but if they stay within the same labor market, they are going to keep the same employees.

We have found time and again that that is really what is holding these plants in Massachusetts. Now, there was an earlier question about moving to the Sunbelt. Actually, the ones that move to the Sunbelt tend to be the major multiplant operations that are building really big plants. The smaller ones with one plant, two plants, the owners, management, and workers all live in pretty much the same area. That is our greatest advantage in Massachusetts.

Mr. Shannon. The reason I ask the question is that it is my experience, knowing many of the people that work in the plant, that they are not moving with the plant because it moves too far away. I am concerned that this might be a situation which is replicated more than you are aware.

Let me ask another question. Maybe this falls under the category of biting the hand that feeds you. But some of the most prosperous companies in my district, companies like Wang Laboratories, Digital Equipment Corp., and others, which are very large companies, are using industrial revenue bonds to help finance construction. Should that kind of financing be available to companies of that size which are able to get below prime rate financing anyway?

Mr. Robert Patterson. I am not familiar with Digital.

Mr. Shannon. I am not sure about Digital.

Mr. Robert Patterson. I think Digital is not. I am familiar with Wang. As you know, Wang has a policy of rehabilitating older buildings and usually locating in distressed areas, most particularly Holyoke, which was assisted by a UDAG grant.

If it weren't for the mix by UDAG which raises the limit to $20 million, which I believe is an extremely progressive policy by the Federal Government, then in many cases Wang would not be able to use it.

So, it is really UDAG in the Holyoke project that made that possible.

Mr. **Shannon**. What about the IRB, though? Let's take my own district. Wang has just built a big office building in the city of Lowell, and they are adding onto that now, and I am delighted. But, I just have to believe that they were going to do that whether or not they could get an industrial revenue bond.

Mr. **Robert Patterson**. They used a UDAG.

Mr. **Shannon**. I have to believe they were going to do it whether or not they got a UDAG for that. I am glad they did. Isn't that the point, though, that we don't know how much new investment goes on as a result of these specific investment incentives and how much does not? You cited a University of Massachusetts study which indicated that a lot of it wouldn't take place without industrial revenue bonds.

There is a study which came out of MIT last year which indicates exactly the opposite. I am just concerned that a targeted incentive only works to the degree that it is targeted to a narrow number of areas. You talk about the commercial area revitalization districts. How many of those are there in Massachusetts now, and how many were there 5 years ago?

Mr. **Robert Patterson**. Oh, there were none 5 years ago because the entire program was new as of 3 years ago. It started from scratch. I would think approximately a third of the communities in Massachusetts have such districts.

Mr. **Shannon**. That is growing, is it not?

Mr. **Robert Patterson**. Yes, but they are all downtown districts. When you drive around Massachusetts, as you do so often, you know it is the heart of those communities that has to come back.

Mr. **Shannon**. Who determines what the area is that will be targeted?

Mr. **Robert Patterson**. In my opinion, it is local politics at its best or worst, depending on your opinion. It is first drawn up by the planning department. Then there is a public hearing on the boundaries and public improvements that are to go into the district when the plan is adopted. Then it has to be adopted by the governing body of the municipality which in most cases is the selectmen or city council plus mayor. Then it has to be approved personally by the official at the State government level, who is the secretary of communities and development.

I do know that he personally looks at these plans and personally looks at the jurisdictions.

Mr. **Shannon**. Those lines are drawn pretty liberally are they not?

Mr. **Robert Patterson**. Well, I think that is a matter of opinion. I think that a very small part of the geographic area of the State, very, very small totally, would be included within those districts.

On the other hand, there is a certain propensity density in our older downtowns which are so distressed to include not only the main street but some of the side streets where this geographic——

Mr. **Shannon**. Just for commercial use, but the industrial use has none of those——

Mr. **Robert Patterson**. Industrial use is not so restricted.

Mr. **Shannon**. Let me just say that——

Mr. **ROBERT PATTERSON**. The theory, Mr. Congressman, is that industrial use is what has been the base of our State's prosperity and brings money into the State. Then when it comes to retail we tend to be talking about the distribution of those sales within the State. That is why we target them to the downtowns.

Mr. **SHANNON**. I know that there are certain areas where IRB's have been essential to the development and creation of new jobs. But I know of plenty of cases, even in my district, where jobs have been relocated from lower income areas to higher income areas and I do not think Government should be giving people incentive to do that. And IRB's have been made available to businesses which would go ahead with those kinds of investments anyway. With your own agency, we see Corning Glass and Wang and Purity Supreme and Marriott Hotels, Zayre's.

Mr. **ROBERT PATTERSON**. The Marriott I think is one of the best uses of the entire program. The Marriott Hotel. A few years ago, if anyone had told me Marriott was going to build in a downtown older city in Massachusetts, they would have laughed you out of the room. I heard it when joining the State government from everyone in the private sector. We were wasting our time trying to channel investments into the downtowns. Forget it. You are fighting the market. Let it go suburban. The hotel you mention is in downtown———

Mr. **SHANNON**. They built there in my opinion because there is a market there and not because of any Government policy.

Mr. **ROBERT PATTERSON**. Sure, but they have to be pushed. Look at the one in Lowell, they are having a hell of a time.

Mr. **SHANNON**. I think they build there because they are convinced they can make money there. Be that as it may, I just don't think we should be providing this subsidized interest rate to large business corporations that can get below prime rate financing anyway. I question how efficient a use of taxpayer dollars that is.

I really think that in the climate we are living in now, with the sorts of deficits we have, we have to find a way to target these programs better. I know you don't disagree with the basic thrust of that, though you might disagree with some of the criticisms I would have of the program overall. I appreciate your testimony.

Mr. **ROBERT PATTERSON**. I would only point out that in terms of raising revenue to narrow the deficit this is absolutely chickenfeed if it raises revenue at all.

Second, when it comes to targeting I couldn't agree with you more and the proposals on the table, including from Governor Garrahy earlier, do involve targeting. However, the use of it by major corporations is a very small and rapidly shrinking part of the national industrial revenue bond program and that is what is so often overlooked.

Mr. **RANGEL**. On behalf of the chairman and entire committee I thank the panel for its testimony. The record will remain open in case some other members have questions.

The next panel: George C. Phillips, acting chairman of the Council of State Hospital Finance Authorities; my friend from the city of New York, Msgr. James P. Cassidy, director of the Department of Health and Hospitals, Archdiocese of New York City; Karl Zeisler, vice president and chief financial officer of Rush-Presbyterian/St. Luke's Medical Center; Anthony J. Taddey, chairman, Health Care Financing Study Group; and Allan Jones, vice chairman of the board and Peter Wright, treasurer and director of the National Health Care Financing Association.

STATEMENT OF GEORGE C. PHILLIPS, JR., ACTING CHAIRMAN, COUNCIL OF STATE HOSPITAL FINANCE AUTHORITIES AND EXECUTIVE DIRECTOR, ILLINOIS HEALTH FACILITIES AUTHORITY

Mr. PHILLIPS. Thank you, Mr. Chairman.

Mr. ANTHONY. Mr. Phillips, all of the panelists' testimony will be accepted in full for the record. You are welcome to read it, or summarize it. Proceed as you wish. We will lead off with Mr. Phillips.

Mr. PHILLIPS. Thank you, Mr. Chairman. With me this morning are the executive directors of the Rhode Island Authority; the assistant director of the New York State Medical Care Facilities Finance Agency; the executive director of the Idaho Authority, as well as myself representing the Illinois Authority. We are all here representing——

Mr. ANTHONY. Excuse me, Mr. Phillips. We are having a little trouble hearing. If you could turn that microphone. Thank you.

Mr. PHILLIPS. We are all here representing the Council of State Hospital Finance Authorities, an association of 19 State authorities each of which is a State agency responsible for the issuance of tax-exempt securities on behalf of nonprofit health care facilities.

The health facilities served by our member authorities are organizations exempt from tax under section 501(c)(3) of the Internal Revenue Code of 1954, which includes many of the Nation's university and church-sponsored hospitals.

The council is concerned by the administration's proposals to impose new restrictions on tax-exempt bonds issued for section 501(c)(3) health care facilities. The council opposes these proposals for the reasons set forth in detail in my prepared statement, which I am submitting for the record. The following is a summary of our views.

We believe the administration proposals are aimed principally at curbing the use of tax-exempt financing for private purposes. We believe tax-exempt financing for charitable institutions serves largely public purposes, and is therefore in our opinion outside the scope of the limitations intended by the administration proposals.

The council believes that any new restrictions on tax-exempt financing will adversely affect the Nation's health care delivery system. Tax-exempt financing has played a substantial role in the supply of capital to the Nation's nonprofit hospitals. The use by nonprofit hospitals of tax-exempt financing has been necessitated by restrictions on other sources of capital, restrictions which in many cases are the products of, or exacerbated by, Federal Government policies.

The ultimate result of restricting tax-exempt financing to charitable hospitals, in the current environment, will be the erosion of the capital base and physical plant of nonprofit hospitals.

At the same time, we doubt that there would be any significant revenue gain from restricting tax-exempt financing by nonprofit hospitals. The loss from the tax exemption of such financing is offset by revenue gains or expenditure reductions which the tax exemption generates. We believe the existing estimates do not properly take into account these offsetting factors, which are discussed in detail in my prepared statement.

When these offsetting factors are taken into account, we believe there is serious doubt that there is any real revenue loss from the exemption of the interest on hospital revenue bonds.

The principal basis for our opposition to the administration proposal, however, is that the council believes these proposals are aimed primarily at the use of tax-exempt financing for commercial and manufacturing purposes, and that the rationale for those restrictions does not apply to financing for tax-exempt institutions.

The first restriction proposed by the administration is the requirement of approval by an elected body or official. This restriction aims to insure that financings serve public purposes. But in the case of financings for section 501(c)(3) organizations, a variety of circumstances insures that the financings will serve public purposes.

First, the fact that the organization is tax exempt means that it operates exclusively for charitable, scientific, or educational purposes. Second, health care facilities must be approved in the certificate of need process, which guarantees that the financing will have been approved after a public hearing. Third, in most States, financings for health care facilities must be approved by a public body to which the legislature has delegated the authority to review and approve bond issuances. Such legislation assures a satisfactory level of political approval of any hospital project.

The second restriction proposed by the administration is the so-called contribution requirement. As in the case of the elected body approval requirement, the objective of the restriction is to insure that revenue bonds serve public purposes, and to insure that the issuing governmental unit is committed to any project.

For the reasons I stated in my discussion of the first proposed restriction, however, there is no need for a "contribution" by State and local governments to test either the public purpose or the commitment of an issuing authority to a hospital financing. Moreover, such a requirement could seriously restrict the availability of tax-exempt financing to health care facilities.

The council objects as well to the requirements that revenue bonds be in registered form and to the limitations on the arbitrage yield which may be earned on such bonds. Both of these requirements would raise the cost of all revenue bonds, and, in the case of arbitrage yield restrictions, might make some particular forms of hospital financing impossible.

The administration proposal would not subject general obligation State and municipal bonds to the registration or arbitrage yield restrictions. For purposes of any restrictions of this kind, we believe that financings undertaken for section 501(c)(3) organizations, because such financings serve public purposes, should be treated in the same manner.

I welcome the opportunity to answer the committee's questions.

[The prepared statement and additional material follow:]

STATEMENT OF GEORGE C. PHILLIPS, JR., EXECUTIVE DIRECTOR, ILLINOIS HEALTH FACILITIES AUTHORITY, ON BEHALF OF THE COUNCIL OF STATE HOSPITAL FINANCE AUTHORITIES

Thank you, Mr. Chairman. I am grateful for the opportunity to be here this morning, and to share with the Committee the views of the Council of State Hospital Finance Authorities concerning the tax proposals set forth in President Reagan's fiscal 1983 budget.

The Council of State Hospital Finance Authorities is a recently formed association of nineteen state authorities, each created under the laws of its respective state. The principal function of each of the Council's member authorities is to administer and monitor the issuance of revenue bonds for nonprofit health care facilities in its respective state. The health care facilities which benefit from the financing are generally organizations exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code. I am Executive Director of the Illinois Health Facilities Authority, one of the members of the Council, and am also the Acting Chairman of the Council at this time.

The principal concern of the Council with the tax recommendations incorporated in the President's budget relates, of course, to the President's proposal to impose new restrictions upon tax exempt financing for private activities. The Council's concern is with the fact that these proposals would apply not only to tax exempt financing for private commercial and manufacturing purposes, but would apply as well to tax exempt financing on behalf of Section 501(c)(3) organizations. The nineteen authorities which comprise the Council of State Hospital Finance Authorities were responsible for administering approximately 40% in dollar volume of all state and municipal bonds issued on behalf of non-profit hospitals during 1981.

The Council of State Hospital Finance Authorities opposes the President's proposed legislation as it affects section 501(c)(3) organizations in general, and nonprofit hospitals in particular. Section 501(c)(3) hospitals include most of the hospitals in the nation which are affiliated with or sponsored by universities, most church affiliated hospitals, and independent charitable hospitals which play a critical role in the delivery of health services to their local communities. These hospitals, in terms of the number of beds, and in research, training, and teaching, play a dominant role in the nation's health care delivery system.

The Council of State Hospital Finance Authorities believes that availability of tax exempt financing to the nation's charitable hospitals, on the terms and in the manner in which such financing is currently available, enables those hospitals to continue to play the vital role they traditionally have played in the American health care delivery system. We do not believe that it has ever been substantiated that, when all primary and secondary consequences of such financing are properly taken into account, such financing entails any measurable revenue cost to the Federal Treasury.

In appearing today, I wish both to address generally the question of the tax exemption for hospital revenue bonds, and to address specific aspects of the Administration proposal. As to the general policy questions raised by hospital revenue bonds, I would like to stress the role of those bonds in supplying capital to the nation's section 501(c)(3) hospitals, and to detail for the Committee reasons why we believe that the revenue gain from restricting or eliminating the tax exemption accorded such bonds would not be substantial. We believe, based on these considerations, that no changes are warranted in the current tax exemption as it applies to revenue bonds used to finance hospital projects.

With respect to the particular restrictions proposed by the Administration, the Council of State Hospital Finance Authorities believes that such restrictions are unnecessary and inappropriate in the context of hospital revenue bonds. The main thrust of the Administration's proposals is to curb the use of tax exempt bond financing for private purposes. Whatever may be the merits of that objective, it is clear that institutions exempt from Federal income tax under section 501(c)(3) do not fall within the intended limitation. Tax exemption for charitable institutions is predicated, in part, on the recognition that such groups provide services which otherwise would become the obligation of government to furnish. Such is clearly the situation affecting charitable nonprofit hospitals. If these institutions did not exist, the medical care and services they provide would be a direct burden upon government. Thus, the availability of tax exempt financing for such groups comports with the underlying rationale of the Administration proposal that the exemption be utilized in support of public purposes.

* * *

In evaluating the effect of the Administration proposals upon nonprofit hospitals, the first step is to understand the dimensions of the capital needs of those hospitals, and the role which tax exempt financing plays in meeting those needs.

It is true that there has been substantial growth in recent years in the use of tax exempt financing by private nonprofit hospitals. But that growth must be understood in light of the erosion of alternative sources of financing for nonprofit hospitals.

The first tax exempt offering issued in connection with a hospital capital project was issued by Connecticut in 1966. In 1968, the majority of the capital requirements of tax exempt hospitals were still satisfied by conventional sources of hospital equity financing -- namely, government contributions, both Federal and state; private contributions; and internally generated funds -- which at that time supplied roughly 60.5% of the capital of charitable hospitals. Only about 39.5% of the capital requirements of these hospitals was supplied by debt finance, and almost all the debt issued by these hospitals was taxable debt.

A substantial market for tax exempt hospital revenue bonds was first developed during the late 1960s and early 1970s. By 1976, a substantial majority of nonprofit hospital capital requirements (about 67.9%) were met by debt financing, and roughly half of this (or about 30-35% of total capital requirements) was satisifed by tax exempt borrowings. In the years since, the proportion of new hospital capital which has been derived from debt financing has remained nearly constant, in the 60-70% range. Tax exempt financing now constitutes roughly 70% of all debt financing by nonprofit hospitals, and thus supplies about half of all new capital raised by those hospitals.

The distribution of sources of capital for the nation's section 501(c)(3) hospitals has been projected to remain along these orders of magnitude throughout the 1980s. The increasing resort by tax exempt hospitals to debt financing has been stimulated by a number of conditions in the hospital industry which will continue throughout the 1980's to lead hospitals to resort to debt in financing their capital projects in roughly the same proportion as in the immediate past. Perhaps the most significant of these is the method of accounting for a return on capital used in determining Medicare and Medicaid reimbursement payments. Under existing regulations, interest is counted as an allowable cost in computing Medicare and Medicaid reimbursements, which are computed upon a cost of service basis, but no amount is allowed as a return on equity to nonprofit entities, although a return on equity is counted as an allowable cost in reimbursing investor-owned hospitals.

Obviously, tax exempt financing plays a significant role in meeting the capital needs of the nation's charitable hospitals. Such hospitals play a dominant role in the nation's overall health care delivery system. This makes clear that serious questions of health policy are raised by the President's proposals as they would affect hospital revenue bonds.

* * *

The most important grounds for opposing new restrictions on hospital revenue bonds is that such restrictions will adversely affect the ability of the nation's charitable hospitals to continue to deliver high quality health care service. Restrictions on tax exempt financing by hospitals will inevitably lead to the undercapitalization of such hospitals, and to the erosion of the financial structure, capital base, and physical plant of the hospitals, and ultimately of the quality of the delivery system. This is because, as the figures cited above suggest, sources of capital other than tax exempt financing have been greatly eroded by a number of developments in recent years. Many of these developments have been created or aggravated by policies of the Federal Government:

* Government financing is clearly no longer a viable source of equity financing for private section 501(c)(3) hospitals. Neither Federal nor state and local assistance to hospital construction can be expected to increase in any substantial amount in the immediate future, nor would we or the hospital industry necessarily welcome a return to programs of direct Government subsidy to hospital capital projects.

* The amount of financing derived from private contributions can be expected to continue to decline as inflationary and recessionary conditions impinge upon the ability and desire of prospective donors to dedicate substantial portions of their wealth or income to charitable purposes. In addition, the rate reductions in the corporate and personal income taxes enacted in 1981 substantially increase the after tax cost to prospective donors of such contributions.

* Earnings accumulation is also not a promising source of financing, and, if hospitals are constrained to rely upon earnings accumulation to any significant extent, the result will be

a shift in hospital capacity from the nonprofit to the for-profit sector.

- Taxable debt does not provide a promising alternative to tax exempt financing. At one extreme, the private placement taxable market offers only a very limited prospect for financing nonprofit hospitals. The private placement market is characterized by a small number of very selective investors who invest in only the strongest hospitals. At the other extreme is the publicly traded securities market. But virtually no independent institution, certainly no nonprofit institution, is able to compete effectively with other issuers in this market, primarily because the average hospital bond issue is very small compared to the average corporate securities issue ($12.2 million for an average hospital revenue bond in 1980, compared to $50 to $70 million regularly reported as the size of debt issues by corporate borrowers). This renders it very difficult to develop an active secondary market in taxable hospital bonds after their initial distribution; no such market now exists.

Accordingly, there is virtually no alternative source of financing which will be able to meet the capital needs of the nation's charitable hospitals without an increase in capital costs to the hospitals greatly disproportionate to whatever cost, if any, the Treasury incurs on account of the exemption of the interest from tax. Consequently, the result of limiting the availability of tax exempt financing to charitable hospitals will be a gradual erosion in the capital base of those institutions. This will result both in the underutilization of health care resources other than physical plant, and a deterioration of health care services provided to the public.

* * *

In addition, in many respects the tax exemption does no more than place charitable hospital borrowers on rough after-tax parity with taxable private borrowers. It must be remembered, in the context of investment by tax exempt hospitals, that such hospitals do not benefit from the variety of tax based incentives to capital investment which are enjoyed by taxable investors, including investor-owned hospitals. Taxable entities claim investment tax credits and enjoy substantial tax benefits from the accelerated cost recovery system enacted under the 1981 tax law. These benefits are not enjoyed by tax exempt hospitals, since they pay no tax. But these benefits enable a taxable borrower, with whom tax exempt hospitals must compete for available capital, to pay a higher rate of interest on any borrowing it undertakes. In an environment where capital financing by taxable borrowers is stimulated by investment tax credits and accelerated cost recovery allowances, restricting the tax exemption on the interest on borrowings by section 501(c)(3) organizations is discriminatory against such organizations.

Indeed, the Administration proposal with respect to tax-exempt bonds issued on behalf of private taxable entities reflects a recognition that the availability of the accelerated cost recovery system and tax exempt financing constitute alternative means of encouraging capital investment; the Administration suggests that when a borrower enjoys the benefit of both, he is enjoying a "double-dipping" of tax benefits. Tax exempt hospitals do not benefit from the capital incentives enjoyed by taxable borrowers. Therefore, tax exemption on borrowings by such hospitals is necessary to place them in a competitive position with that of private borrowers.

In this context, too, I believe it is important to address assertions, suggested by the Congressional Budget Office among others, that tax exempt financing leads to the construction of unnecessary hospital capacity. The Council of State Hospital Finance Authorities strongly believes that such suggestions are without foundation. In the first place, it must be remembered that there are substantial government and market place controls on hospital construction. Under section 1122 of the Social Security Act, depreciation and interest expense associated with capital expenditures are not reimbursed unless certain necessary planning approvals are obtained. Accordingly, hospitals will not undertake a financing in the absence of a certificate of need issued by the appropriate state board. Perhaps most important, the market itself exerts controls on the construction of unnecessary projects, since investors will scrutinize any proposed project to determine that the need for the project in the territory the project is designed to serve is such that there will be a reasonable expectation that the project will generate sufficient revenues to service the debt.

A causal relationship between the issuance of tax exempt hospital bonds and the level of aggregate hospital construction has never been demonstrated. The record shows that tax exempt financing has been used principally to refinance existing debt, usually to reduce the cost of servicing outstanding debt, and to renovate existing facilities or to convert them to new uses, rather than for new construction. Since the early 1970's, when tax exempt financing first became generally available to hospitals, and first came to be used to a significant extent, the number of acute care beds per thousand population has not increased substantially. Moreover, there has been a negative correlation between the issuance of bonds and the amount of construction, including renovation, replacement, and facility conversion. From 1972 to 1979, the dollar volume of tax-exempt hospital bond issues increased 670%; but hospital construction starts declined by 40%, and construction completed by 36%. From 1974 to 1979, between 25 and 46 percent of the volume of tax exempt bonds issued were for refinancing existing debt at lower interest rates.

Accordingly, I believe there is no basis for suggestions that tax exempt financing leads to excess hospital capacity. Such financing has been used to fill the legitimate capital needs of a major segment of the nation's hospital industry. Those legitimate needs can be expected to grow over the immediate future, at a time when alternatives to tax exempt financing have been eroded and remain highly unreliable. Accordingly, we believe that this form of financing is essential to maintaining the capital base of the nation's private nonprofit institutions, and that measures to restrict it, like those the Committee now has before it, will jeopardize the ability of these hospitals to maintain adequate physical plant.

* * *

At the same time that hospital revenue bonds play a substantial role in enabling charitable hospitals to maintain their capital base, the Council of State Hospital Finance Authorities believes that it has never been demonstrated that these bonds, when all primary and secondary consequences of their issuance are taken into account, result in a loss of Federal revenues. The Congressional Budget Office has estimated that the revenue savings from eliminating these bonds will amount to about $100 million in the first year following the imposition of new restrictions, rising to about $600 million annually by 1986. We believe those estimates are substantially overstated for at least four significant reasons:

- First, the estimates do not account for the reductions which such financings generate in Federal, state, and local assistance and insurance program reimbursement payments. Tax exempt hospital financing reduces Federal, state and local health care reimbursement payments, so the savings to beneficiary hospitals are passed back to third party cost payors in the form of lower reimbursements for interest expense. In 1980, we believe the reduction in Medicare and Medicaid reimbursement payments offset at least 27% of whatever revenue losses the tax exemption entails for the Treasury. Another 6% were offset by reduced state and local government reimbursement payments under Medicaid, and other assistance and insurance programs.

* Second, the estimates do not account for increased revenues resulting from the economic activities stimulated by hospital investment in modernization and improvement as well as the expansion of needed hospital capacity. As I indicated above, and as the Administration's analysis of the tax exempt bond issue generally implies, tax exemption for revenue bonds operates in many respects to stimulate investment activity in the same way expedited capital allowances or investment credits operate. The secondary effect of such tax expenditures is an increase in economic activity, which in turn generates a partially offsetting increase in revenue.

* Third, the estimates overstate the amount of revenue loss caused by the displacement of taxable issues. Many issues of tax exempt debt would not be replaced by taxable debt issues. A substantial number of investors in the tax exempt market would shift investment from tax exempt securities not into taxable securities, but into real estate or other assets the increment in the value of which is not currently taxable.

* Fourth, the estimates do not account for the rate reductions effected by the 1981 Tax Act. The across-the-board 25% rate reduction, and, more important, the reduction of the top maximum rate from 70 to 50 percent, tend to reduce the after tax value of tax exempt bond issues, and to increase the tax exempt interest rate. The income tax rate reductions thus result in less tax loss as a result of exempt bonds, since displaced taxable investments would have been taxed at a lower rate relative to the tax exempt rate.

When all of these circumstances are taken into account and added together, I believe it is possible that their combined effect wipes out the revenue loss estimated by the CBO. Therefore, we believe this Committee and the Congress as a whole should be skeptical of any claim that there will be any measureable revenue gain from proposals to limit the use of hospital revenue bonds.

* * *

In summary, then, the Council of State Hospital Finance Authorities opposes any new restrictions on tax exempt bonds as unnecessary in budget terms, and potentially destructive in terms of health care policy. These considerations are pertinent to any proposal to restrict or eliminate tax exempt financing for hospital revenue bonds.

The Administration proposal, of course, does not propose outright elimination of tax exempt financing for section 501(c)(3) hospitals, but, rather, proposes certain specific new conditions on their issuance. This is because the proposed restrictions are applicable to all so-called "private purpose" bonds. I would like to comment briefly on some of the specific aspects of the Administration proposals.

Four of the restrictions proposed by the Administration are of particular concern to us. The first is the requirement that, in addition to the approval of health planning agencies, rate setting bodies and bond issuing authorities, any exempt bond offering receive the approval of an elected official or body of the issuing government unit. The second is the requirement that financially pressed units of state and local government make additional financial contributions to tax exempt hospital construction projects. The third is the requirement that bonds be in registered form, and that information concerning the holders be furnished to the Internal Revenue Service. The final restriction of concern to us is the limitation on arbitrage yields on reserve funds and during the construction period. The other restrictions proposed by the Administration are by their terms applicable only to industrial development bonds, although the entire group is presented as applicable to all bonds affected by the proposal.

These proposals are concerned with and directed at industrial revenue bonds. Although they apply to obligations issued on behalf of section 501(c)(3) organizations, their impact upon such groups is, in general, misplaced, because the questions both of the rationale for the restrictions and of their effect are quite different than in the case of IDBs.

1. The public hearing and elected official approval requirement

The first restriction to which we object is the requirement that any financing be approved by the highest elected official or legislative body of the governmental unit issuing the bonds, and that the approval be given only after a public hearing on the proposed bond issue. The reasons for this restriction stated in the Treasury's explanation of the proposal is to insure that tax exempt obligations issued for private activities serve a genuine and valid public purpose.

This proposed restriction may serve this purpose in the context of garden variety industrial development bonds. Congressional concern in recent years has focused on the use of tax exempt financing for new and different uses. In the context of state and municipal financing employing tax exemption for these novel ends, it may be that a useful purpose would be served by requiring that any such bonds be approved after a public hearing by the highest elected official of the jurisdiction, particularly where no hearing requirement exists at present under local law.

But a host of circumstances which exist at present insure that bonds issued on behalf of section 501(c)(3) organizations, including in particular those issued to finance health care facilities, serve genuinely public purposes.

First, and perhaps most important, the borrowing organization itself has an exemption from Federal income tax, an exemption available only if the organization is organized and operated exclusively for charitable, educational or scientific purposes.

Second, all health care facility construction projects in all states must be approved by the certificate of need program as administered by the state. While it is true that certificates of need concern the facility itself and not the financing vehicle as such, it is clear that the certificate of need process insures that any particular facility will serve the needs and purposes of the area in which the facility is to be located. Certificates of need are granted only after public hearings, often at both the local and state levels.

Third, at least in states which have created authorities of the kind our Council represents, revenue bonds will be approved by the health care facility financing authority. In most states this is done after a public hearing which pertains to the financing itself. The authority members are usually appointed by the Governor of the state with the advice and consent of the State Senate. These officers are accordingly delegated, by act of the state legislatures, the authority for giving public approval to health care facility bond projects. In light of the existence of this process, we do not see what purpose would be served by requiring that further approval be given to each financing by the highest elected official personally or by special act of the state legislature.

In some states, there are additional or alternative hearing or approval requirements for health care facility financing projects, such as the requirement of approval of a control board at a public meeting, or of the highest financial officer of the state, or the like. Such requirements also serve to insure that a project serves public purposes.

All of these circumstances distinguish tax exempt financing on behalf of section 501(c)(3) organizations from industrial revenue bonds and so-called private "exempt purpose" bonds. Those truly private purpose bonds are not issued for organizations which have the imprimatur of the Federal Government as serving genuine public purposes; nor are they used exclusively for facilities which are subject to anything resembling the certificate of need process. In addition, most are not approved by special financing agencies established for the purpose of supervising and monitoring bonds issued in a particular area of public concern, as in the case of the state health facilities financing authorities.

Accordingly, we believe the public hearing and elected official approval requirements are wholly superfluous in the context of financing for section 501(c)(3) organizations. That requirement would add a new layer of cost to financing of health care facilities, and would introduce unnecessary delays and uncertainties into the process of undertaking such financing.

2. The financial contribution requirement

The second restriction the Administration would impose upon the issuance of tax exempt bonds for section 501(c)(3) organizations would be the requirement that the governmental unit issuing the debt make a financial contribution to the facility equal to one percent (1%) of the cost of the facility. The Administration proposal permits the issuing governmental unit to satisfy the commitment by assuming or guaranteeing the debt, or by designating bonds as general obligation bonds of the government. A technical explanation of the Administration proposal issued by the Treasury states that this financial contribution requirement will also be met by a general tax exemption under state law provided to exempt organizations, although it states that tax abatements generally applicable to facilities will not count toward satisfying the commitment requirement.

Again, this proposal emanates from concerns affecting IDBs and is intended to restrict the use of such bonds only to such projects as merit local financial support. The requirement is, in effect, inherently met in the case of nonprofit hospital bonds.

We do not believe the contribution requirement is necessary to insure that hospital revenue bonds will have a genuine public purpose. The fundamental reason why bonds issued on behalf of section 501(c)(3) organizations are granted exemption is that section 501(c)(3) organizations serve public purposes, and in that respect they shoulder responsibilities which would otherwise have to be borne by the government, whether Federal, state, or local. Under present law whether a hospital revenue bond serves a public purpose is tested, first, by the existence of the Federal tax exemption and, second, by the fact that the state approves the project by means of its own locally adopted procedures. We believe that these two conditions constitute a sufficient test of the public purpose of any municipal bond, including in particular hospital revenue bonds.

Accordingly, we do not believe a contribution requirement of any kind is appropriate in the context of hospital revenue bonds or indeed of other bonds issued for section 501(c)(3) organizations. The Administration proposal does, however, include a caveat which provides that the amount of a tax exemption granted to an organization under state tax law, parallel or comparable to the exemption accorded by section 501(c)(3), would be counted toward the contribution requirement. We believe that if Congress decides to impose a contribution requirement of some sort, a qualification that the amount of a state tax exemption be counted toward satisfaction of the requirement would be essential to the preservation of tax exempt hospital financing. A contribution requirement not qualified by such a provision would virtually destroy the ability of the nation's section 501(c)(3) hospitals to undertake tax exempt financing. We do not believe it is realistic to expect that the nation's hard-pressed state and local governments would, on a widespread basis, be able to make material major commitments out of general revenues to section 501(c)(3) hospital capital projects. Some states and localities, too, would face constitutional limitations which would preclude their making contributions of the kind the Administration proposal makes a condition of any financing. Even qualified by a rule, that the amount of a state tax exemption will count toward the required contribution, a contribution requirement could have a serious effect on tax exempt financing for health care facilities.

3. The registration and information requirements

The third restriction proposed by the Administration of concern to the Council is the restriction that each bond be in registered form and that information concerning its issuance be reported by the state or local government to the Internal Revenue Service.

The principal problem this restriction would cause is a simple one of cost. Based on the experience of financings which have been undertaken in recent months which are virtually identical except with respect to whether they are in bearer or registered form, a registration requirement could add from 50-70 basis points to the cost of bonds, that is, one-half to seventh-tenths of one percent of the interest rate.

We understand that registration of bonds and the provision of information to the IRS serves important tax compliance purposes which are of concern to the Administration and to this Committee. We do not wish to minimize our sympathy with these concerns. However, we believe that there is no justification for distinguishing bonds issued on behalf of section 501(c)(3) organizations from general obligations bonds of municipal and state governments from the standpoint of the question of imposing a registration requirement. Ordinary general obligation municipal bonds would not be subject to the registration requirement under the Administration proposals. Bonds issued on behalf of section 501(c)(3) organizations, as we have stressed, serve public purposes, and therefore should be treated in the same way as other municipal and state bonds, rather than in the way bonds issued for private purposes -- industrial development bonds and so-called exempt purpose bonds -- are treated.

4. The arbitrage restrictions

The fourth and final limitation of concern to the Council are the restrictions proposed by the Administration on the investment yield and the use of proceeds of tax exempt obligations on reserve funds and funds held during construction. The principal difficulty which such a restriction would pose for tax exempt health care facility financing is the same as that which would be imposed by the registration requirement -- that it would increase the cost of the bonds. One recent study shows that, depending upon the assumption one makes concerning the rate of interest at which bond proceeds can be reinvested, the arbitrage restriction would add from 3-6% of the amount of obligations which would have to be issued to finance a $20 million construction project, and would increase the present value of the debt service payments a borrower would be required to make by 6 to 12%. In addition, such restrictions would make impossible certain forms of financing now in use. Unlike the registration requirement, however, comparably serious tax compliance concerns are not involved; rather, this facet of the Treasury proposal seems to involve a concern over the use of tax exemption for private purposes and the possibility of subsidizing activities which do not serve genuinely public purposes.

In the context of bonds issued on behalf of section 501(c)(3) organizations, we do not believe, as we have stressed throughout our statement here, that such concerns are appropriate. Therefore, we do not believe that the arbitrage limitation proposed by the Administration should be imposed on bonds issued for section 501(c)(3) organizations.

* * *

For the reasons I have set forth, the Council opposes any restrictions on hospital revenue bonds as a measure for reducing the 1983 budget deficit. We believe that such restrictions would have an unfortunate effect on the health care system of the nation, in terms of the erosion of the capital base of the nation's hospitals, and would, in terms of national tax policy, result at best in raising an insignificant amount of revenue.

I welcome the opportunity to answer any questions you may have.

Embargoed until Wednesday, March 31, 1982

TAX-EXEMPT HOSPITAL BONDS: KEY QUESTIONS AND ANSWERS

by George C. Phillips, Jr.*

This year Congress will consider various proposals to restrict tax-exempt revenue bond financing. Some of the restrictions under consideration would substantially reduce the availability of tax-exempt financing to private, not-for-profit hospitals. Although efforts to restrict the issuance of tax-exempt bonds have been made in the past, the threat to tax-exempt hospitals has never been so direct.

While it may be appropriate to restrict the availability of tax-exempt financing to some users, there is no justification for any substantial reduction in health care facilities' access to the tax-exempt market. Indeed, none of the policy concerns advanced against tax-exempt hospital financing supports any change in current law as it applies to tax-exempt hospitals:

- Health policy considerations weigh strongly in favor of retaining the availability of tax-exempt hospital financing. Significant amounts of hospital capital are needed for facility renovation, replacement, conversion and expansion projects. Most of this capital must be raised by issuing debt because of the substantial impairment by the Federal Government of tax-exempt hospitals' other sources of capital. As to the concern that tax-exempt hospital financing leads to excessive hospital expansion, this contention has never been demonstrated and all the evidence shows that this has not occurred.

- The budget policy concern of reducing Treasury revenue losses, presently a major impetus behind efforts to restrict tax-exempt financing, is less applicable to hospital bonds than to any other use of tax-exempt financing. This is primarily because of offsetting reductions in Medicare and Medicaid reimbursement payments for interest expense. For this and other reasons, tax-exempt hospital financing is far less expensive than generally estimated.

- The tax policy issues of whether a public purpose is served by the project financed, reductions in tax rate "progressivity," and the "uncontrollability" of tax expenditures have little force when applied to hospitals. Tax-exempt hospitals serve the unquestionably public purpose of maintaining the health of the community, the same essential public purpose served by public institutions. Any reduction in the progressivity of the tax rate structure is amply justified by this public purpose. In addition, effective governmental controls on hospital capital projects and on the issuance of bonds to finance these projects are already provided by state and local health planning agencies, rate-setting bodies, and bond issuing authorities. Indeed, because tax-exempt hospital financing is administered by a decentralized system of state and local governmental decisionmakers, this form of financial assistance is a particularly appropriate role for the Federal Government in our federal system.

---

* see page 12

o The credit policy concerns of capital allocation distortions and increased municipal bond interest rates also have little force in the case of hospitals. The extensive federal involvement in health care financing has an overwhelming effect on the allocation of capital to hospitals, and the volume of tax-exempt hospital bonds is too small a fraction of the bond market to affect significantly municipal bond rates.

None of the policies supporting the restriction of tax-exempt financing would be advanced as much as our health care system would be damaged by any substantial decrease in the availability of this essential form of hospital financing.

Recent Restrictions on Substantially Different Tax-Exempt Bond Users

Congress has restricted the availability of tax-exempt financing twice in the past two years.1/ In 1980, Congress acted to severely restrict the issuance of mortgage subsidy bonds for single family residences and to terminate their use on December 31, 1983.2/ In 1981, Congress focused its attention on certain users of small-issue industrial development bonds (IDBs). Hearings were held on perceived abuses of IDB financing, such as the financing of recreational establishments and retail stores, and a report was issued recommending certain restrictions on their use.3/ However, there are substantial factual and policy differences that distinguish hospital bonds from these other types of tax-exempt financing considered by Congress. These other uses were not in furtherance of an essential public purpose such as maintaining the health of the community, were not performed by tax-exempt charitable institutions, and were not subject to any effective form of governmental control.

PROPOSALS UNDER CONSIDERATION

The Reagan Administration, in its FY 1983 budget, has proposed restricting tax-exempt revenue bond financing. Some of the restrictions under consideration as this article is written would virtually terminate the availability of tax-exempt financing to private, not-for-profit hospitals. One such proposal would require that financially hard pressed units of state or local government make additional financial contributions to tax-exempt hospital construction projects, beyond the substantial commitments already made to these institutions in the form of tax abatements. Such additional contribution requirements are not likely to be met in many cases. Another proposal would require that in addition to the approvals of health planning agencies, rate-setting bodies, and bond issuing authorities, an elected official or body also approve the project. This proposal and others would needlessly delay construction and increase project costs.

QUESTIONS AND ANSWERS

The operation of tax-exempt hospital financing and the consequences of substantially restricting its use requires an examination of complex and interrelated questions of health, budget, tax and credit policy. These questions must be answered in the context of the present state of our nation's tax-exempt hospitals and the other elements of our health care system, including: the demand for hospital capital; the expected changes in other federal policies affecting the availability and cost of capital for hospitals; and other unique circumstances of hospital financing.

The balance of this article is a discussion of these questions.

HEALTH POLICY

Q. In this period of budgetary restraint, what special circumstances exist to justify this federal benefit?

A. Tax-exempt financing for private, tax-exempt hospitals is justified by the purposes for which this financing is used and by the impairment of these institutions' traditional sources of capital by actions of the Federal Government.

Estimates of the amount of capital which will be needed by hospitals in the 1980s range from $130 to $190 billion--more than double the amount of hospital investment in the 1970s.4/ This capital is needed to renovate old, inefficient facilities, to replace obsolete equipment (especially in teaching and research hospitals), and to comply with various licensing requirements. It is also needed to convert existing facilities to new uses in response to changed modes of patient care. The introduction of more competition into the health care system is expected to increase the amount of capital required for many of these purposes. Where medically underserved areas exist, caused by population shifts and an aging population, capital is needed for expansion.

Tax-exempt financing for tax-exempt, private, not-for-profit hospitals is especially justified by the charitable nature of these institutions. Historically, these hospitals have improved the health of their communities by providing medical services to those in need, regardless of their ability to pay.

Tax-exempt hospital financing is also justified because the traditional sources of capital for private, tax-exempt hospitals--earnings accumulation, charitable contributions and debt issuance--have been impaired by a variety of Federal Government actions:

- Earnings accumulation has been reduced, and in some cases entirely eliminated, by federal and state reimbursement payments which do not fully cover the costs of service. Only about 85 percent of costs are reimbursed under Medicare and 70 percent under Medicaid.[5] These percentages will be reduced further by recently enacted reductions in federal reimbursement payments,[6] and future additional reductions are expected. Earnings accumulation has also been reduced because of increasing amounts of charitable services and bad debts in a recessionary economy.

- Charitable contributions to tax-exempt hospitals are expected to decline as a result of the personal and corporate income tax rate reductions enacted by the 1981 Tax Act.[7]

- These reductions in earnings accumulation and charitable contributions will necessitate the increased use of debt to finance capital projects. The proportion of construction expenditures funded by debt issuance has been projected to increase from 78 percent in 1977 to over 90 percent in 1983.[8] Creditworthiness will decrease as debt-to-equity ratios increase and federal reimbursement payments are reduced. These factors will make it increasingly difficult for hospitals to receive investment-grade bond ratings. Under such circumstances, entry into the 30 year long-term bond market becomes much more difficult, often necessitating the use of short-term borrowing. Such borrowing can result in a continual need to roll over increasing amounts of short-term debt, with the ultimate effect of eroding the financial structure of the institution to the point where long-term debt is completely unavailable.

- Current and foreseeable high interest rates make borrowing even at tax-free rates very costly. Much borrowing by hospitals in 1981 occurred despite high interest rates because of the inability of some institutions to delay construction further, because of the rapid escalation in construction costs coupled with the requirement that the project be completed within cost targets mandated by the health planning agency, and because of fears that Congress might restrict tax-exempt hospital borrowing.

Borrowing at taxable rates would be extremely difficult for many nonprofit hospitals in today's market. The shorter maturity of taxable issues would result in insufficient cash flows because reimbursements for depreciation would be less than required payment of principal. Moreover, the additional cost of taxable issues would not be fully offset by increased interest expense reimbursements.

- o Hospitals must compete for funds in credit markets. The borrowing needs of the Federal Government, $41 billion in the first quarter of 1982 alone, as well as the large credit needs of utilities and municipalities, are likely to keep rates from falling substantially for some time.

- o This competition for credit has been increased by the Federal Government's recent increases in the supply of tax-exempt investments. The new "All Savers Certificates" and the expansion of the exemption for Individual Retirement Accounts are prime examples.

- o The corporate and personal tax rate reductions of the 1981 Tax Act have increased tax-exempt interest rates by reducing the spread between taxable and tax-exempt rates from the 30 to 35 percent range to the 15 to 20 percent range.

Q. Would tax-exempt hospital financing continue to be justified if proposals to create a more competitive health care environment are implemented?

A. This form of hospital financing would not only continue to be justified, but would be necessary. Vigorous competition among health care providers will be hindered if tax-exempt hospitals, an essential part of our nation's health care system, suffer substantial, perhaps irreparable, erosion of their financial structure, capital base and physical plant. In addition, recent actions of the Federal Government have already biased this competition against tax-exempt hospitals by enhancing the ability of investor-owned institutions to accumulate capital, while hindering the capital accumulation of tax-exempt institutions. For example:

- o The Accelerated Cost Recovery System and the corporate tax rate reductions of the 1981 Tax Act assists investor-owned institutions in accumulating capital; tax-exempt hospitals received no such benefit.

- Because tax-exempt hospitals serve proportionately more patients whose care is financed by Medicare and Medicaid than do investor-owned institutions,[9] they will suffer more severe revenue decreases as the result of reimbursement reductions. This disparity is expected to increase as investor-owned hospitals become reluctant to serve Medicare and Medicaid patients at reduced reimbursement levels, and these patients are shifted to tax-exempt hospitals.

- Tax-exempt borrowing helps to put the borrowing cost of tax-exempt hospitals on a basis comparable to the after-tax borrowing cost of investor-owned hospitals. Tax-exempt hospitals cannot take full advantage of tax incentives, such as the deduction of interest and depreciation expenses and investment tax credits, which benefit taxable institutions. Tax-exempt borrowing by tax-exempt institutions is an equalizer between tax-exempt and investor-owned institutions, not an advantage. The denial of tax-exempt financing to tax-exempt hospitals would amount to another action in favor of investor-owned institutions at the expense of tax-exempt institutions.

- Certain Medicare policies' amount to additional disparate treatment directly affecting capital accumulation: Medicare reimburses investor-owned hospitals, but not tax-exempt hospitals, for return on equity, and does not reimburse tax-exempt hospitals for the costs of seeking charitable gifts.

Q. Are there effective controls on hospital construction and the issuance of tax-exempt hospital bonds?

A. Yes. There are effective governmental and marketplace controls on its use. Under section 1122 of the Social Security Act, depreciation and interest expenses associated with a capital expenditure are not reimbursed unless the necessary planning approvals are obtained.[10] Because denial of such reimbursement in the case of any significant capital expenditure would seriously jeopardize repayment of the debt, a certificate of need or similar approval is a practical precondition to any tax-exempt financing.

In addition, bond issuing authorities can effectively deny tax-exempt financing to projects which are not economically sound or not in the interest of the people of the state. Most important, because the hospital is ultimately responsible for repayment of the debt issued, investors demand that the proposed project is necessary; otherwise the revenues necessary for debt repayment will not be forthcoming.

Q. Has tax-exempt financing led to the construction of unneeded hospital capacity?

A. A causal relationship between the issuance of tax-exempt hospital bonds and the amount of hospital construction has never been demonstrated. Rather, the facts show that tax-exempt financing has been used primarily to refinance existing debt, usually at lower costs, and to renovate existing facilities or convert them to new uses, such as ambulatory care centers which reduce the number of beds and reduce health care costs.

o Since the early 1970s when tax-exempt financing became generally available to hospitals and tax-exempt hospital bonds were issued in significant amounts, the number of acute care beds per thousand population has not increased substantially (from over 4.2 in 1972 to less than 4.5 in 1979). In addition, the rate of growth in this statistic has not increased at all since at least 1960.11/

o Since 1972, there has been a strong negative correlation between the issuance of tax-exempt hospital bonds and the amount of hospital construction, including renovation, replacement and facility conversion. From 1972 to 1979, the volume of tax-exempt hospital bond issues has increased 670 percent, and the volume used for construction has increased 660 percent12/ while hospital construction starts declined by 40 percent13/ and hospital construction completed declined by 36 percent14/ (all figures are in constant dollars).

o Of 113 institutions completing tax-exempt financing through 15 state health facilities financing authorities (of 20 authorities active nationwide) in 1978 and 1979, 24 increased bed capacity, while 7 reduced capacity and 82 left capacity unchanged.15/

o From 1974 to 1979, between 25 and 46 percent of the volume of tax-exempt hospital bonds issued were for refinancing at lower interest rates.16/ Such refinancing lowers the costs of health care by reducing interest expenses.

Q. Is tax-exempt financing an efficient way of assisting hospital investments?

A. Yes. The efficiency (the ratio of hospital savings to Treasury revenue losses) of tax-exempt hospital financing has been substantially understated by the Treasury and the Congressional Budget Office (CBO). It is likely to be higher than the efficiency of the alternative, direct federal subsidy programs, for the following reasons:

- Actual Treasury revenue losses are much less than generally estimated, and may even be less than hospital savings.
- Administrative costs in the issuance of tax-exempt financing are less than comparable administrative costs in federal direct subsidy programs.[17]
- Another important but often overlooked aspect of efficiency is the ratio of the value of the construction project to its cost. Because tax-exempt financing can be arranged much more quickly than a direct subsidy could be approved, construction cost increases caused by delays (generally estimated to be one percent per month), which add nothing to the value of the project, are minimized.
- The principal source of inefficiency identified by the Treasury and the CBO (returns to high-bracket investors in excess of the after-tax returns on their taxable investments) will be substantially decreased by the recent reduction in the top marginal tax rate from 70 to 50 percent.[18]

Q. Is this benefit targeted to those projects where capital is most needed?

A. The benefits of tax-exempt financing are directed to needed projects by a decentralized system of state and local government control, rather than by the Federal Government. State health planning agencies, state rate-setting bodies, state bond issuing authorities, and investors effectively direct these benefits to needed projects.

BUDGET POLICY

Q. Would the termination of tax-exempt hospital financing result in a significant increase in Treasury revenues?

A. No. The actual revenue loss caused by the issuance of tax-exempt hospital bonds is much less than the $100 million (in FY 1982) estimated by the CBO, for the following reasons:

1. The CBO estimates do not account for offsetting reductions in federal, state and local assistance and insurance program reimbursement payments.

- Tax-exempt hospital financing reduces federal, state and local health care reimbursement payments because savings to beneficiary hospitals are passed back to third-party cost-payers in the form of lower reimbursements for interest expenses. The Federal Government receives direct benefits through reduced

Medicare and Medicaid reimbursement payments, and will benefit even more if Medicaid is federalized as the President has proposed. State and local governments similarly benefit through reduced reimbursement payments in Medicaid and other assistance programs and by reduced premium payments to private insurers, for whom state governments are sometimes the largest customer.

- The reduction in Federal Medicare and Medicaid reimbursement payments in 1980 offset at least 27 percent of the CBO-estimated Treasury losses.19/
- Another six percent of the CBO-estimated revenue losses were offset by reduced state and local government reimbursement payments under Medicaid and other assistance and insurance programs in 1980.20/

2. The CBO estimates do not account for increased tax revenues resulting from investment-stimulated economic activity.

- All federal tax and direct expenditures are assumed to increase economic activity and thereby increase tax revenues in the amount of approximately 30 percent of the amount of the expenditures. Expenditures which directly induce productive capital investments, however, have a greater than average economic stimulus.21/ This is especially true where nonproductive speculative investments, which are most often used by high bracket taxpayers who invest in tax-exempt securities, are displaced by productive investment activities.

3. The CBO estimates overstate the amount of revenue losses caused by displaced taxable issues.

- Many issues of tax-exempt debt would not be replaced by taxable debt issues. Most refinancing (which accounted for between 25 and 46 percent of all tax-exempt hospital bonds from 1974 to 1979)22/ would not be undertaken at taxable rates.
- In addition, many investors in taxable hospital securities, such as pension funds, pay little or no federal income tax. The replacement of such debt by tax-exempt bonds therefore causes little loss in tax revenues.

4. The CBO estimates do not account for the tax rate reductions of the Economic Recovery Tax Act of 1981 (the 1981 Tax Act).

- The across-the-board 23 percent rate reductions, and more important, the reduction of the top rate from 70 to 50 percent, will tend to reduce the number of tax-exempt bonds issued by increasing the tax-exempt interest rate. The tax rate reductions will also result in less tax loss per tax-exempt bond issued because any displaced taxable investments would have been taxed at a lower rate.

- The reduction in the top tax rate from 70 to 50 percent will increase the percentages of offsetting interest expense reimbursement savings above the 27 percent federal and 6 percent state and local offsets which existed in 1980. By decreasing the difference between the tax brackets of the "marginal" bond buyer and buyers in the highest bracket, hospital savings as a percentage of revenue losses, and hence offsetting savings as a percent of revenue loss, will increase.

TAX POLICY

Q. Does the use of tax-exempt financing reduce the equity and progressivity of our tax system?

A. All tax preferences reduce progressivity. However, this reduction will be lessened by the lowering of the top tax bracket from 70 percent to 50 percent. In addition, any such decrease in tax progressivity is amply justified by the charitable nature of the institutions receiving the benefit of this tax-exmeption and by the public purposes served by the investments assisted.

Q. Are tax-exempt hosital bond revenue losses uncontrollable because they do not require Congressional approval each year?

A. It is true that these revenue losses are not subject to the appropriations process, as is the case for all tax expenditures. However, as discussed above, there are other effective governmental and marketplace controls on the issuance of hospital bonds.

CREDIT POLICY

Q. Does this form of federal assistance for hospital financing distort the free market's allocation of capital?

A. The extensive Federal involvement in health care financing, and thus indirectly in both the supply of and demand for health facilities capital, makes comparisons to capital allocation in a theoretical free market extremely difficult. Tax-exempt hospital financing, however, is less intrusive on the operation of a free market than other forms of Federal involvement in health care.

Q. Does the amount of hospital tax-exempt bonds significantly increase the interest rates, and thus the borrowing costs, for other state and local governmental purposes?

A. There is no evidence that the volume of tax-exempt hospital bonds issued in any area is having a significant effect on municipal bond interest rates. Inflation and federal fiscal and monetary policies are by far the dominant influences on municipal bond rates. In addition, it is no more appropriate to attribute any increase in municipal bond rates to hospital bonds than to attribute such increases to bonds issued for other purposes because the interests served by hospital bonds are no less public than those served by other municipal bond issues. By far the most significant effect on state and local governments of the use of tax-exempt hospital bonds is to decrease their expenditures for health care. This is especially so in states with urban hospitals.

Q. Has the volume of hospital tax-exempt bond issues increased the cost of borrowing to the Federal Government?

A. A comparison of the relative amounts of hospital tax-exempt bonds issued to the level of Treasury and corporate bond issues indicates that the effect of hospital bond issues on Treasury interest rates must be quite small. In 1981, $93 billion of U.S. Treasury were issued, $34 billion of publicly offered corporate bonds (with private issues bringing the corporate total to $47 billion), $45 billion of long-term tax-exempt bonds (with shorter-term tax-exempt financing bringing the tax-exempt total to $80 billion), and $5 billion of tax-exempt hospital bonds.23/ Therefore, tax-exempt hospital bonds accounted for 11 percent of long-term tax-exempt bonds issued and 6 percent of all tax-exempt issues, and equalled 5 percent of the volume of Treasury bonds issued and 3 percent of the total public bond market.

CONCLUSION

The problem of attracting affordable capital is expected to be the critical issue facing hospitals in the 1980's. Approximately $150 billion will be needed by hospitals in the 1980's for renovation, replacement of obsolete equipment, conversion of facilities to adapt to a new, more competitive environment, and expansion in response to significant demographic changes.

In 1979, tax-exempt financing was the source of 55 percent of all hospital construction capital.24/ Because of reductions in earnings accumulation and income from philanthropy, caused in major part by Federal Government reimbursement and tax policies, debt financing will become even more important in the future. Restricting the access of tax-exempt hospitals to the tax-exempt market would make it extremely difficult for many hospitals to finance these projects. This inability to undertake needed capital improvement projects would reduce the quality of patient care in a hospital's service areas and shift the burden of health care to other area institutions, especially already hard pressed public hospitals.

Those hospitals able to finance at taxable rates would suffer cash flow problems and incur higher interest expenses, thus increasing the reimbursement expenses of Federal, state and local governments under Medicare, Medicaid, and other assistance and insurance programs.

The ability of the tax-exempt sector of the health care industry to raise needed capital has been severely and disproportionately impaired by actions of the Federal Government and by the state of the bond market. Further impediments would not materially advance the budget, health, tax or credit policy goals advanced as justification for restriction on tax-exempt hospital financing and would substantially impair the ability of the private, not-for-profit sector of our health care system and the system as a whole to maintain the level of health care we have worked so hard to attain.

---

*This article will appear in the April 1982 issue of Hospital Financial Management Journal, Volume 36, Number 4.

Mr. Phillips is the Executive Director of the Illinois Health Facilities Authority, 35 East Wacker Drive, Suite 2188, Chicago, Illinois 60601, (312)782-9447.

Note: The author is indebted to Paul C. Fiduccia, an attorney with the Washington D.C. office of Winston & Strawn, for his invaluable assistance in preparing this article.

Footnotes

1/ See generally, G. Gayer, The Case For Hospital Tax-Exempt Bonds, Hospital Financing Management, June 1981 at 58. A. Fine and H. Pell, Will Hospital Financing Survive Congressional Scrutiny, Hospital Financial Management, June 1981, at 55.

2/ Omnibus Reconciliation Act of 1980, PL 96-499, Title IX. Also in 1980, the Carter Administration proposed to restrict the issuance of tax-exempt hospital bonds by requiring federal health planning approval of each project seeking such financing; this proposal was withdrawn by the Reagan Administration and was not considered by Congress. 45 Fed. Reg. 41,096-99 (June 17, 1980).

3/ Oversight Committee's Report and Recommendations Relating to Small Issue Industrial Revenue Bonds, May 14, 1981. In a related action, Congress acted to prevent the IRS from expending any funds to enforce a revenue ruling (81-216) which effectively would prohibit state governments from issuing umbrella or pooled bond issues. However, this compromise amendment to the Continuing Resolution funding the Federal Government until March 31, 1982 also provided that enforcement would be prohibited only in the case of IDBs backed by the state or local government, used by firms which had less than $25 million of capital expenditures in a three year period and where the proceeds were not used for various recreational purposes. The adoption of these limits was an ominous precedent for future Congressional action on IDBs and perhaps other revenue bonds as well.

4/ J. Valiante, The Dimensions of Capital Requirements, presentation to the National Health Lawyers Association, January 20, 1982; M. Hernandez, S. Valimahomed, The Capital Formation Environment of the 1980s, Hospital Corporate Planning, A Report of the 1980 National Forum on Hospital and Health Affairs, at 116.

5/ Case for Bonds at 62, see also, P. Pine, M. Gornick, J. Lubitz, M. Newton, Analysis of Services Received Under Medicare by Specialty of Physician, Health Care Financing Review, September 1981, at 97 (in 1977, Medicare paid an average of 19.5 percent less than average submitted charges); L. Lewin, R. Derzon, R. Marguiles, Investor-Owneds and Nonprofits Differ in Economic Performance. Hospitals, July 1, 1981, 56, 58 (nonprofit hospitals price their services to Medicare and Medicaid patients at or below cost).

6/ Omnibus Budget Reconciliation Act of 1981, PL 97-35.

7/ See C. Clotfelter, L. Salamon, The Federal Government and the Nonprofit Sector: The Impact of the 1981 Tax Act on Individual Charitable Giving (a study for the Independent Sector) The Urban Institute, August 1981, at 23.

8/ Evaluation of Future Hospital Capitalization, a study commissioned by Standard & Poor's Corporation and prepared by Booz, Allen & Hamilton (hereinafter "Booz, Allen"), October 16, 1978, at 7, 8, 21, 22.

9/ L. Lewin, R. Derzon, R. Marguiles, Investor-Owneds and Nonprofits Differ in Economic Performance. Hospitals, July 1, 1981, 52, 53.

10/ See 42 U.S.C. §1320 a-1.

11/ Booz, Allen, at 4.

12/ Congressional Budget Office, Tax Subsidies for Medical Care: Current Policies and Possible Alternatives (hereinafter "Tax Subsidies"), January 1980, at 49.

13/ American Hospital Association, Report on Tax-Exempt Hospital Financing (hereinafter "AHA Report"), at 6.

14/ Bureau of the Census.

15/ AHA Report at 9.

16/ See Tax Subsidies at 49.

17/ Administrative costs of the Hill-Burton program do not provide a fair comparison because they do not include many costs of financing--costs such as those for document preparation, placement fees, and legal fees--and also because the level of monitoring of that program has been criticized as insufficient by the General Accounting Office. See GAO Report, Hospital Loan Assistance Programs: Actions Needed to Reduce Anticipated Defaults, HRD-79-64, June 27, 1979.

18/ This source of inefficiency is the return received by high-bracket investors above that necessary to attract them from taxable investments. The interest rate spread between taxable and tax-exempt bonds, historically 30-35 percent, reflects the benefit to the borrower and the break-even marginal tax rate at which investors are indifferent between holding taxable and tax-exempt bonds. Investors of tax-exempt bonds in brackets above this marginal rate get a higher return than investors in the marginal tax bracket require to clear the market. Although factors other than the top marginal tax rate undoubtedly influence the tax rate to tax-exempt rate spread, that spread has not narrowed to 15 to 20 percent, indicating a major reduction in this source of inefficiency.

19/ Offsetting reimbursement savings are the product of interest savings to hospitals and the percent of hospital revenues which are paid by the Federal Government. In 1978, the Senate Budget Committee estimated that the interest expense savings of institutions benefitting from tax-exempt financing equalled 75 percent of Treasury revenue losses. On the average, the Federal Government paid 37 percent of the revenues of hospitals benefitting from tax-exempt financing in 1980, primarily through Medicare and Medicaid payments. Because these payments include reimbursement for interest expense on a pro rata basis, 37 percent of the savings, which were assumed to equal 75 percent of revenue loss, was passed back to the Federal Government in the form of reduced payments. See generally; R. Gibson and D. Waldo, National Health Expenditures, 1980, Health Care Financing Review September 1981 (hereinafter "National Health Expenditures"), at 13, 14, 42, 48. (Of the total expenditures for hospital care, the Federal Government paid 41 percent and state and local governments paid 13 percent in 1980. Total hospital expenditures equalled $99.6 billion. Subtracting expenditures at institutions which cannot benefit from the use of tax-exempt financing (Veterans Administration, $4.8 billion, DOD, $3.3 billion, Public Health Services, $1.1 billion, and State and local hospitals, $6 billion) leaves $84.4 billion; Federal Medicare ($26.3 billion) and Medicaid ($5.2 billion) are 37% of this $84.4 billion.)

20/ State and local governments paid 8 percent of hospital revenues through Medicaid and other assistance and insurance program payments. This 8 percent share of the 75 percent savings equals 6 percent of the revenue loss. See Id. (Of the $84.4 billion spent on hospitals which can benefit from tax-exempt financing, $6.8 billion (8 percent) was spent by State and local governments: State Medicaid payments ($4.3 billion), State and local workmen's compensation ($1.9 billion) and public assistance ($.6 billion). This does not include $6 billion spent on state and local hospitals.)

21/ In hearings on small issue IDBs, a University of Chicago economist, Dr. Roger C. Kormendi, disagreed with CBO and Treasury IDB revenue loss estimates and their underlying assumptions. Hearings in the House Committee on Ways and Means, Subcommittee on Oversight, April 8-10, 1981. In the study on which his testimony was based, he and co-author Thomas T. Nagle (also an economics professor at the University of Chicago's Graduate School of Business) had concluded that revenue losses due to IDB sales were only one-sixth the amount estimated by CBO. See also R. Kormendi and T. Nagle, A Summary of the Nature and Effect of Small-Issue Industrial Development Bonds (1981); R. Kormendi and

T. Nagle, The Interest Rate and Tax Revenue Effects of Mortgage Revenue Bonds, July 26, 1979. Other witnesses cited a 1980 study by the economic consulting firm of Norman B. Ture, who is now Treasury Undersecretary for Tax and Economic Affairs, concluding that the economic activity generated by IRBs causes net gains in federal tax revenues. Norman B. Ture, Economic and Federal Revenue Effects of Changes in the Small Issue Industrial Development Bond Provisions, at 6.

22/ See Tax Subsidies, at 49.

23/ See, e.g., The Bond Buyer, January 4, 1982, at 18.

24/ M. Lightle, Changes in Sources of Capital for Health Care Providers, presented at National Health Lawyers Association, January 20, 1982.

For further information, contact:

WALTER J. UNGER
ASSOCIATE DIRECTOR
PROFESSIONAL AFFAIRS

HOSPITAL FINANCIAL MANAGEMENT ASSOCIATION
1050 17TH STREET, NW., SUITE 580
WASHINGTON, D.C. 20036
202/296-2920
Residence 301/654-8510

Mr. **Rangel**. Thank you, Mr. Phillips.

Msgr. James P. Cassidy, glad to see you again. Welcome to the committee.

STATEMENT OF MSGR. JAMES P. CASSIDY, DIRECTOR, DEPARTMENT OF HEALTH AND HOSPITALS, ARCHDIOCESE OF NEW YORK, ON BEHALF OF THE CATHOLIC HEALTH ASSOCIATION

Reverend **Cassidy**. Yes, it is good to be in Washington rather than New York.

Mr. **Rangel**. It is snowing in New York this morning?

Reverend **Cassidy**. A blizzard.

Mr. **Rangel**. It is good to be in the South now.

Reverend **Cassidy**. I am Monsignor Cassidy.

The Catholic Health Association represents 633 Catholic hospitals having 169,928 beds and 260 long-term care facilities having 32,670 beds. These health care facilities are sponsored by religious orders and dioceses of the Catholic Church.

This morning, I would like to do two things: First, summarize the testimony written by the Catholic Health Association and share with you some specifics with respect to how the administration's tax-exempt proposals would affect the hospitals with which I am affiliated and patients which we serve.

First, our written testimony indicates that elements of the proposal Mr. Phillips has brought out, particularly financial contribution, public hearing, and approval requirements could have a severe and adverse impact on the not-for-profit hospitals and health care facilities.

For this and the reasons detailed in our testimony, the Catholic Health Association recommends that if the Congress feels compelled to modify the statute with respect to tax-exempt financing for private purposes, that such modifications not apply to exempt organizations.

Specifically, the not-for-profit hospitals as described in section 103(b)(3) of the statute. In general, the Catholic Health Association believes that the administration's proposal is too broad brush, like the meat cleaver approach.

With respect to tax-exempt financing for not-for-profit hospitals. It is a solution where there is really not a problem. The Treasury Department's arguments in favor of the proposal do not stand up when viewed in the context of tax-exempt financing for not-for-profit hospitals.

The interest rates which State and local governments may pay are more affected by actions of the Federal Government than they are by the tax-exempt financing by not-for-profit hospitals. The net revenue loss to the Treasury is marginal if any occurs at all.

Any revenue gained by eliminating the tax-exempt financing for not-for-profit hospitals would be offset by increased costs the Federal Government would experience in medicare, medicaid, CHAMPUS and every good or service purchased from the private sector.

It seems strange to us that the administration seems unaware that if they do away with it, it will actually cost them more money with regards to medicare and medicaid. With regard to health policy, there is no health policy considerations which would provide justification to warrant restricting access to the tax-exempt financing on the part of the not-for-profit hospitals.

Some people allude to a perceived overbedding problem as justification. A review of the current projects in our hospitals so that 80 percent of the projects are involved in renovation, less than 20 percent are involved in any new beds.

However, the administration's proposal strikes at capital financing for renovation, needed beds and services in addition to new construction.

In short, it is a major overkill. There are a number of health policy considerations which would more than justify preserving access for tax-exempt financing. The more medicaid and medicare patients the hospital treats, the more it erodes its capital base.

With respect to access to capital, not-for-profit hospitals already widely are viewed as being at serious disadvantage. Implementation of the proposal would only increase the advantage of the for-profit hospitals in this area.

As we know in New York, there really are no not-for-profit hospitals or very few. Perhaps the best justification for preserving access to the tax-exempt financing for the not-for-profit hospitals, the type of hospital that would hurt first and most severely.

In almost every large inner city in the country there are not-for-profit hospitals whose patient loads are primarily medicare, medicaid and the poor.

These hospitals are in most instances relatively weak financially, both because of inadequacies of the medicare and medicaid reimbursement mechanisms and because of their high charity load.

In well-managed hospitals they currently receive a triple-A rating on their tax-exempt bonds. Frequently, these hospitals are older facilities. They have been built early in the century and in the near-future will be among the first to attempt to raise capital to renovate or replace worn out physical plant.

If tax-exempt financing is restricted or eliminated as a result of implementing the administration's tax-exempt bond proposal, many of these hospitals also will be eliminated from the taxable bond market.

Because of their relatively weak financial condition, bond rating agencies are likely to give these hospitals taxable bonds a double-B rating, a rating which is not salable. If these hospitals fail because their worn out physical plants cannot pass building, fire and safety codes, because they cannot obtain the capital necessary to renovate or replace the physical plant, who is to pick up their patient load?

There are not enough public hospitals to fulfill such an expanded need. The not-for-profit hospitals are not merely public purpose, they are essentially public purpose entities. I think what we are saying is that basically if the proposal were to go through, it would actually cost them more money, because they would have to increase medicare and medicaid.

Second, the hospitals that are going to be really severely hurt by this are going to be the hospitals that are most needed, the hospitals in the inner city that are receiving mainly the poor.

The other hospitals in other areas will not have the same needs. I think to make it more concrete for us, I think we could give two examples on the New York situation. One is St. Vincent's Hospital in New York, which has an operating budget of $100 million a year and lost $2 million last year, basically in free services to the poor.

They have a bond issue for $90 million. They were able to get that and it helps them, but they still have some work to do. But that would have never been feasible if they didn't get tax-exempt bonds.

What would have happened is that over a period of time, they would not be able to meet code, they would go out of existence and that whole area of New York City would not be served by that hospital. Also, I guess as the chairman realizes, Flower Fifth Avenue Hospital is a 166-bed speciality hospital for the severely mental disabled individual, probably the best hospital in the country for the severely retarded. It is based in east Harlem.

They are planning a 500-bed nursing home which would lower current costs by $45 a patient/day. This will add 700 jobs to a high unemployment area. The construction and related financing costs approved by the health system agency and New York State Department of Health are $29,000 per bed, which is 50 to 100 percent less expensive than comparable projects.

While hospitals are fiscally viable health care facilities, yet without tax-exempt bonds, they would be precluded from construction and the long-term-care patients would continue in acute care facilities.

So, we feel so many of the projects that are there would not be feasible at all if we cannot have tax-exempt bonds. Thank you for your attention.

[The prepared statement follows:]

STATEMENT OF THE CATHOLIC HEALTH ASSOCIATION OF THE UNITED STATES, PRESENTED BY MSGR. JAMES P. CASSIDY, PH. D., ARCHDIOCESE OF NEW YORK

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

THE CATHOLIC HEALTH ASSOCIATION (CHA) REPRESENTS 633 CATHOLIC HOSPITALS HAVING 169,928 BEDS AND 260 LONG-TERM CARE FACILITIES HAVING 32,670 BEDS. THESE HEALTH CARE FACILITIES ARE SPONSORED BY RELIGIOUS ORDERS AND DIOCESES OF THE CATHOLIC CHURCH.

CATHOLIC HOSPITALS CAN BE FOUND IN THE INNER CITIES SERVING LARGE PROPORTIONS OF MEDICARE, MEDICAID AND CHARITY CARE PATIENTS. CATHOLIC HOSPITALS CAN BE FOUND SERVING RURAL COMMUNITIES. CATHOLIC HOSPITALS CAN BE FOUND AMONG THE RANKS OF THE TEACHING HOSPITALS AND THE TERTIARY CARE CENTERS.

BECAUSE OF THE LEVEL OF COMMUNITY SERVICE REPRESENTED BY CATHOLIC HOSPITALS AND THE IMPORTANCE OF TAX-EXEMPT FINANCING TO A CONTINUATION OF THAT SERVICE, THE ASSOCIATION WILL FOCUS ITS TESTIMONY ON THOSE ASPECTS OF THE ADMINISTRATION'S TAX PROPOSAL THAT DEAL WITH TAX-EXEMPT FINANCING.

TAX-EXEMPT BONDS FOR PRIVATE ACTIVITIES

THIS PART OF THE ADMINISTRATION'S TAX PROPOSAL FOCUSES ON THE USE OF TAX-EXEMPT BONDS BY ENTITIES OTHER THAN UNITS OF GOVERNMENT.

THE ADMINISTRATION'S PROPOSAL ON TAX-EXEMPT BONDS WOULD PLACE RESTRICTIONS ON THE ISSUANCE OF ALL TAX-EXEMPT BONDS ISSUED BY UNITS OF STATE AND LOCAL GOVERNMENT FOR OTHER THAN THEIR OWN USE. THE APPLICATION OF THE ADMINISTRATION'S PROPOSAL COVERS A WIDE RANGE OF TYPES OF BONDS, FROM SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS, TO STUDENT LOAN BONDS, TO BONDS

USED TO FINANCE CAPITAL PROJECTS OF NOT-FOR-PROFIT HOSPITALS.

CHA HAS REVIEWED THE ADMINISTRATION'S TAX-EXEMPT FINANCING PROPOSAL, AND ASSESSED THE IMPACT OF THAT PROPOSAL ON TAX-EXEMPT FINANCING OF CAPITAL PROJECTS OF NOT-FOR-PROFIT HOSPITALS. IT IS OUR CONCLUSION THAT ELEMENTS OF THE ADMINISTRATION'S PROPOSAL COULD HAVE A SEVERE AND ADVERSE IMPACT ON ACCESS TO CAPITAL FINANCING OF NOT-FOR-PROFIT HEALTH CARE FACILITIES.

TO SUPPORT THAT CONCLUSION, OUR TESTIMONY WILL:

1. IDENTIFY THOSE PARTS OF THE ADMINISTRATION'S PROPOSAL THAT IMPACT TAX-EXEMPT FINANCING FOR NOT-FOR-PROFIT HEALTH CARE FACILITIES.
2. DELINEATE CHA'S GENERAL AND SPECIFIC CONCERNS WITH THE ADMINISTRATION'S PROPOSAL.
3. WITH REGARD TO HEALTH POLICY, MAKE THE CASE THAT:
   A. THERE ARE NO HEALTH POLICY CONSIDERATIONS WHICH WOULD PROVIDE SUFFICIENT JUSTIFICATION TO WARRANT RESTRICTING ACCESS TO TAX-EXEMPT FINANCING ON THE PART OF NOT-FOR-PROFIT HOSPITALS.
   B. THERE ARE A NUMBER OF HEALTH POLICY CONSIDERATIONS WHICH WOULD MORE THAN JUSTIFY PRESERVING ACCESS TO TAX-EXEMPT FINANCING FOR NOT-FOR-PROFIT HEALTH CARE FACILITIES.

CHA CONCLUDES WITH A REQUEST THAT IF THE HOUSE COMMITTEE ON WAYS AND MEANS BELIEVES IT MUST AMEND THOSE PORTIONS OF THE TAX STATUTE THAT DEAL WITH TAX-EXEMPT FINANCING, IT DO SO WITHOUT IMPACTING ADVERSELY ON NOT-FOR-PROFIT HOSPITALS' ACCESS TO THAT FINANCING.

ELEMENTS OF THE ADMINISTRATION'S TAX-EXEMPT BOND PROPOSAL WHICH WOULD AFFECT NOT-FOR-PROFIT HOSPITALS

THE PROPOSAL WOULD IMPOSE SEVERAL ADDITIONAL REQUIREMENTS ON STATE AND LOCAL GOVERNMENTS ISSUING TAX-EXEMPT BONDS FOR "PRIVATE PURPOSES", WHICH WOULD INCLUDE THE CAPITAL FINANCING FOR A NOT-FOR-PROFIT HEALTH CARE FACILITY.

1. THE HIGHEST ELECTED OFFICIAL OR LEGISLATIVE BODY OF THE GOVERNMENTAL UNIT ISSUING THE BONDS AND IN WHICH THE PROJECT IS LOCATED MUST FIRST HOLD A PUBLIC HEARING ON THE WORTH OF THE PROJECT, AND THEN IT MAY APPROVE THE BONDS.
2. IN CASES OF BONDS ISSUED AFTER 1985, THE UNIT OF GOVERNMENT ISSUING THE BONDS MUST MAKE A FINANCIAL CONTRIBUTION, COMMITMENT OR OBLIGATION TO THE CAPITAL PROJECT FOR WHICH BONDS ARE BEING ISSUED. THE FINANCIAL CONTRIBUTION MUST BE EQUAL TO 1% OF THE FACE VALUE OF THE BONDS.
3. POSITIVE ARBITRAGE WILL NOT BE PERMITTED. TREASURY WILL NOT PERMIT A RETURN ON FUNDS RAISED THROUGH THE ISSUANCE OF BONDS AND INVESTED DURING THE CONSTRUCTION PERIOD GREATER THAN THE INTEREST RATE ON THE BONDS.

WHILE THE ADMINISTRATION'S TAX-EXEMPT BOND PROPOSAL INCLUDES SEVERAL OTHER REQUIREMENTS, THEY DO NOT APPEAR TO AFFECT TAX-EXEMPT FINANCING FOR CAPITAL PROJECTS OF NOT-FOR-PROFIT HEALTH FACILITIES.

CRITIQUE OF THE ADMINISTRATION'S TAX-EXEMPT BOND PROPOSAL

CHA'S CONCERNS WITH THE ADMINISTRATION'S TAX-EXEMPT BOND PROPOSAL ARE BOTH GENERAL AND SPECIFIC.

GENERAL:

CHA IS CONCERNED THAT:

- TREASURY HAS DEVELOPED A BROAD BRUSH PROPOSAL TO SOLVE PROBLEMS PERCEIVED WITH A SPECIFIC TAX-EXEMPT FINANCING VEHICLE.
- TREASURY'S ARGUMENTS IN SUPPORT OF THIS PROPOSAL ARE NOT VALID ESPECIALLY WHEN CONSIDERED IN THE CONTEXT OF TAX-EXEMPT FINANCING FOR CAPITAL PROJECTS FOR NOT-FOR-PROFIT HOSPITALS.

"...BROAD BRUSH PROPOSAL...": THE ADMINISTRATION'S TAX-EXEMPT BOND PROPOSAL WOULD APPEAR TO APPLY TO ALL "PRIVATE PURPOSE TAX-EXEMPT BONDS ISSUED BY STATE AND LOCAL GOVERNMENT". ALTHOUGH SECRETARY REGAN'S TESTIMONY BEFORE THE HOUSE WAYS AND MEANS COMMITTEE ON FEBRUARY 2 DOES CONTAIN REFERENCES TO POSSIBLE PROBLEMS OR ABUSES WITH SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS (IDBS), THE ADMINISTRATION'S PROPOSAL APPEARS TO BE DEVELOPED MORE FROM A PHILOSOPHICAL PERSPECTIVE THAN IN REACTION TO PERCEIVED PROBLEMS WITH THE VARIOUS TAX-EXEMPT FINANCING VEHICLES TO WHICH THIS PROPOSAL WOULD APPLY. FROM THE AVAILABLE LITERATURE IN SUPPORT OF THE ADMINISTRATION'S TAX PACKAGE, IT WOULD APPEAR THAT THIS PROPOSAL HAS BEEN PUT FORWARD WITHOUT ANY EFFORT ON THE PART OF TREASURY TO ASSESS ITS IMPACT ON THE VARIOUS TAX-

EXEMPT FINANCING VEHICLES TO WHICH IT WOULD APPLY.

CHA HAS ASSESSED THE POSSIBLE IMPACT ON TAX-EXEMPT FINANCING OF CAPITAL PROJECTS OF NOT-FOR-PROFIT HOSPITALS AND HAS CONCLUDED THAT ELEMENTS OF THIS ADMINISTRATION PROPOSAL COULD HAVE SEVERE AND ADVERSE IMPACT ON THE ACCESS TO CAPITAL FINANCING FOR NOT-FOR-PROFIT HEALTH CARE FACILITIES. THE ADMINISTRATION'S PROPOSAL IS ALSO A SOLUTION FOR A PROBLEM OR ABUSE THAT DOES NOT EXIST IN THIS PARTICULAR SECTOR.

TREASURY ARGUMENT: THE TREASURY DEPARTMENT HAS PUT FORTH TWO ARGUMENTS IN SUPPORT OF ITS PROPOSAL. THESE ARGUMENTS ARE THAT INCREASED GROWTH IN THE USE OF TAX-EXEMPT FINANCING HAVE:

- CAUSED HIGHER INTEREST RATES FOR STATE AND LOCAL FINANCINGS; AND,
- CAUSED REVENUE LOSSES TO THE FEDERAL TREASURY.

THESE ARGUMENTS ARE FLAWED AND PARTICULARLY SO WHEN VIEWED IN THE CONTEXT OF TAX-EXEMPT FINANCING FOR CAPITAL PROJECTS OF NOT-FOR-PROFIT HOSPITALS.

... HIGHER INTEREST RATES FOR STATE AND LOCAL FINANCINGS: CHA IS UNAWARE OF ANY STUDY WHICH SHOWS THAT INCREASES IN TAX-EXEMPT FINANCING FOR NOT-FOR-PROFIT HOSPITALS HAS CAUSED OR WILL CAUSE INCREASES IN INTEREST RATES WHICH MUST BE PAID BY STATE AND LOCAL GOVERNMENTS ON THEIR TAX-EXEMPT FINANCING. HOWEVER, IF, AS SUGGESTED BY TREASURY, WE ARE TO SUPPOSE THAT INCREASED DEMAND FOR TAX-EXEMPT FINANCING WILL DRIVE UP INTEREST RATES, THEN SHOULD WE NOT FIRST LOOK TO THE COMPOSITION AND PRIME SOURCE

OF THIS INCREASED DEMAND? IN 1981, MARKET DEMAND WAS:

PUBLICLY OFFERED CORPORATE BONDS	$ 34 BILLION
PRIVATELY OFFERED CORPORATE BONDS	13 BILLION
TOTAL CORPORATE BONDS	$ 47 BILLION
LONG-TERM TAX-EXEMPT BONDS	$ 45 BILLION
SHORT-TERM TAX-EXEMPT BONDS	35 BILLION
TOTAL TAX-EXEMPT BONDS	$ 80 BILLION
U.S. TREASURY ISSUES	$ 93 BILLION
TOTAL PUBLIC BONDS	$173 BILLION

IN THAT SAME YEAR DEMAND FOR HOSPITAL TAX-EXEMPT BONDS WAS $5 BILLION.

FROM THESE FIGURES IT WOULD APPEAR THAT HOSPITAL TAX-EXEMPT BONDS ARE A VERY SMALL PERCENTAGE OF:

LONG-TERM CARE TAX EXEMPT BONDS	11%
ALL TAX-EXEMPT BONDS	6%
ALL PUBLIC BONDS	3%

FROM THESE FIGURES IT WOULD SEEM THAT THE ENTITY HAVING THE MOST EFFECT ON THE BOND MARKET IS THE FEDERAL GOVERNMENT. WITH $93 BILLION IN 1981, IT ACCOUNTED FOR 54% OF THE PUBLIC BOND MARKET. IT WOULD APPEAR THAT THE FINANCING NEEDS OF THE FEDERAL GOVERNMENT HAVE A LARGER EFFECT ON THE INTEREST RATES THAT STATE AND LOCAL GOVERNMENTS MUST PAY THAN ANY OTHER ENTITY IN THE BOND MARKET. THEREFORE, IF INTEREST RATES THAT STATE AND LOCAL GOVERNMENTS MUST PAY IS IDENTIFIED AS A PROBLEM, IT WOULD SEEM TO BE MOST PRODUCTIVE TO LOOK AT THE FEDERAL GOVERNMENT'S OWN ACTIVITIES IN THE BOND MARKET FOR A SOLUTION TO THAT PROBLEM.

IN FACT, RATHER THAN CONTRIBUTING TO THE FINANCIAL PROBLEMS OF STATE AND LOCAL GOVERNMENTS, TAX-EXEMPT FINANCING OF HOSPITALS ACTS TO REDUCE EXPENDITURES AND MAY EVEN INCREASE THE REVENUES OF THESE GOVERNMENTS.

TAX-EXEMPT FINANCING FOR HOSPITALS RESULTS IN:

- LESS EXPENSIVE EMPLOYEE HEALTH INSURANCE PREMIUMS TO STATE AND LOCAL GOVERNMENT.
- LESS EXPENSIVE MEDICAID PROGRAMS FOR STATE GOVERNMENT AND IN SOME CASES COUNTY GOVERNMENT.
- LESS EXPENSIVE GOODS AND SERVICES WHICH STATE AND LOCAL GOVERNMENTS PURCHASE FROM THE PRIVATE SECTOR. (HEALTH INSURANCE FOR EMPLOYEES IS NOT AN INSIGNIFICANT COST OF PRODUCTION.)

IN ADDITION, IN MANY COMMUNITIES THE NOT-FOR-PROFIT HOSPITAL IS ONE OF ITS LARGEST EMPLOYERS. IT MAY ALSO BE AMONG THE LARGEST PURCHASERS OF GOODS AND SERVICES, THEREBY PROVIDING ADDITIONAL JOBS IN A COMMUNITY'S ECONOMY. TAX-EXEMPT FINANCING IS THE PRIMARY SOURCE OF CAPITAL OF MANY SUCH HOSPITALS. IF HOSPITAL ACCESS TO TAX-EXEMPT FINANCING IS RESTRICTED OR CURTAILED, IT CANNOT FAIL TO IMPACT ADVERSELY THE STRONG ROLE WHICH THE HOSPITAL PLAYS IN A COMMUNITY'S ECONOMY.

REVENUE LOSSES TO THE FEDERAL GOVERNMENT: THE ADMINISTRATION IN ITS TESTIMONY BEFORE THE COMMITTEE ON WAYS AND MEANS SUGGESTS PRIVATE PURPOSE TAX-EXEMPT FINANCING REPRESENTS LOST REVENUE TO THE FEDERAL GOVERNMENT. THAT CONTENTION MAY BE ARGUABLE IN GENERAL TERMS, BUT IN THE CONTEXT OF TAX-EXEMPT FINANCING FOR HOSPITALS, IT IS MUCH LESS ARGUABLE.

THE CONGRESSIONAL BUDGET OFFICE HAS ESTIMATED THAT LOSSES IN FEDERAL REVENUES AS A RESULT OF TAX-EXEMPT HOSPITAL BONDS WILL BE $100 MILLION IN FY '82, $200 MILLION IN FY '83 AND $300 MILLION IN FY '84. HOWEVER, THESE PROJECTIONS FAIL TO TAKE INTO CONSIDERATION THAT TAX-EXEMPT HOSPITAL FINANCING REDUCES THE COST TO THE FEDERAL GOVERNMENT FOR:

- MEDICARE,
- MEDICAID,
- HEALTH BENEFITS OF FEDERAL EMPLOYEES,
- CHAMPUS,
- EVERY GOOD AND SERVICE THAT THE FEDERAL GOVERNMENT PURCHASES FROM THE PRIVATE SECTOR.

FURTHERMORE, IF HOSPITALS ARE FORCED INTO THE TAXABLE BOND MARKET IT DOES NOT AUTOMATICALLY FOLLOW THAT THE TREASURY WILL RECEIVE PROPORTIONATE INCREASES IN REVENUES. MANY INVESTORS IN TAXABLE HOSPITAL BONDS SUCH AS PENSION FUNDS ARE THEMSELVES TAX-EXEMPT AND THEREFORE THE INTEREST EARNED ON THEIR INVESTMENTS IS TAX-EXEMPT.

SPECIFIC CONCERNS WITH THE ADMINISTRATION'S PROPOSAL:

CHA'S SPECIFIC CONCERNS RELATE TO THE FOLLOWING PARTS OF THE ADMINISTRATION'S TAX-EXEMPT BOND PROPOSAL:

- ARBITRAGE,
- PUBLIC HEARING AND APPROVAL BY ELECTED OFFICIAL OR LEGISLATIVE UNIT,
- FINANCIAL CONTRIBUTION, COMMITMENT OR OBLIGATION.

ARBITRAGE: THE ADMINISTRATION'S PROPOSAL WOULD EXTEND PROHIBITIONS AGAINST POSITIVE ARBITRAGE TO RESERVE FUNDS AND FUNDS INVESTED DURING THE TEMPORARY CONSTRUCTION PERIOD. UNDER

THE PRESENT LAW AND RULES, POSITIVE ARBITRAGE CAN OCCUR ON RESERVE FUNDS AND INVESTMENTS MADE DURING THE CONSTRUCTION PERIOD.

WITH RESPECT TO INVESTMENTS MADE DURING THE CONSTRUCTION PERIOD, AN EXPLANATION MAY BE HELPFUL.

NOT-FOR-PROFIT HOSPITALS RAISE CAPITAL FUNDS THROUGH FLOATING TAX-EXEMPT BONDS. ON THE DAY CONSTRUCTION BEGINS, THE TRUSTEES FOR THE BOND HOLDERS RECEIVE 100% OF THE MONIES RAISED. SINCE 100% OF THE MONIES RAISED CANNOT BE SPENT ON DAY ONE, THE MONIES ARE OFTEN INVESTED IN SHORT-TERM INVESTMENTS THAT MATURE IN CONCERT WITH THE NEED TO MAKE PAYMENTS DURING THE CONSTRUCTION PERIOD. HOPEFULLY THESE INVESTMENTS ARE MADE IN INSTRUMENTS WHICH RETURN A HIGHER RATE OF INTEREST THAN THE HOSPITAL HAS TO PAY OUT. THE DIFFERENCE IN THE TWO INTEREST RATES RESULTS IN ARBITRAGE.

WITH RESPECT TO RESERVE FUNDS HOSPITALS ARE OFTEN REQUIRED, AS A CONDITION OF THE FINANCING, TO SET UP A DEBT SERVICE RESERVE FUND EQUAL TO ONE YEAR'S DEBT SERVICE ON THE FINANCING. THE MONIES FOR THE FUND ARE DERIVED FROM THE PROCEEDS OF THE BOND ISSUANCE. THE MONIES IN THE FUND ARE INVESTED, HOPEFULLY AT RATES HIGHER THAN THE HOSPITAL IS PAYING ON THE BONDS. ARBITRAGE IS THAT MONEY WHICH IS THE NET RETURN ON THE INVESTMENT AFTER THE HOSPITAL PAYS OUT INTEREST ON THE BORROWED FUNDS.

IF ARBITRAGE IS EXPECTED TO OCCUR AS PART OF THE FINANCING, THE MONIES DERIVED FROM ARBITRAGE ARE INCLUDED IN THE CALCULATION A HOSPITAL AND ITS FINANCING TEAM MAKE WHEN THEY ESTABLISH THE AMOUNT OF MONEY NEEDED TO COMPLETE THE CAPITAL PROJECT. SINCE

THE MONEY DERIVED AS A RESULT OF ARBITRAGE IS USED TO PAY COSTS ASSOCIATED WITH THE PROJECT, THE COST CALCULATIONS ARE LESS THAN WOULD OTHERWISE BE THE CASE. IF THE ADMINISTRATION'S ARBITRAGE PROPOSAL IS IMPLEMENTED IT WILL MERELY CAUSE HOSPITALS TO INCREASE THE AMOUNT OF MONEY TO BE BORROWED TO SUPPORT CAPITAL PROJECTS.

ELECTED OFFICIAL: UNDER THE ADMINISTRATION'S PROPOSAL, THE HIGHEST ELECTED OFFICIAL OR LEGISLATIVE BODY OF THE UNIT OF GOVERNMENT MUST APPROVE THE BONDS. PRIOR TO SUCH AN APPROVAL, A PUBLIC HEARING MUST BE HELD TO GIVE MEMBERS OF THE PUBLIC THE OPPORTUNITY TO COMMENT ON THE CAPITAL PROJECT AND THE BOND ISSUANCE.

HOSPITALS AND NURSING HOMES OFTEN OBTAIN THEIR FINANCING THROUGH AUTHORITIES ESTABLISHED BY UNITS OF STATE OR LOCAL GOVERNMENT. THIS PROPOSAL COULD PROVE TO BE DEVASTATING TO HOSPITALS AND NURSING HOMES THAT USE STATEWIDE AUTHORITIES TO OBTAIN THEIR FINANCING.

THEIR TAX-EXEMPT FINANCING APPLICATIONS WOULD HAVE TO COMPETE FOR THE GOVERNOR'S ATTENTION NOT ONLY WITH ALL OTHER TAX-EXEMPT FINANCINGS IN THE STATE BUT ALSO WITH ALL THE OTHER DUTIES AND OBLIGATIONS A GOVERNOR OR STATE LEGISLATURE MAY HAVE. IF THIS REQUIREMENT IS TO BE ONE OF SUBSTANCE RATHER THAN FORM, AT THE

STATE LEVEL, AND PARTICULARLY IN THE LARGER STATES, SUCH A PUBLIC HEARING AND APPROVAL REQUIREMENT WOULD CREATE SUCH A BOTTLENECK IT WOULD BE TANTAMOUNT TO DENYING HOSPITALS ACCESS TO TAX-EXEMPT FINANCING.

WHERE STATEWIDE BOND ISSUING AUTHORITIES EXIST, THEY ARE INSTRUMENTALITIES OF THE STATE GOVERNMENT. THEIR MEMBERS ARE USUALLY APPOINTED BY THE GOVERNOR. CHA SUBMITS THAT ACTION BY THESE STATEWIDE AUTHORITIES SHOULD SATISFY THE PUBLIC HEARING AND APPROVAL BY ELECTED OFFICIAL REQUIREMENT.

FINANCIAL CONTRIBUTION: UNDER THE ADMINISTRATION'S PROPOSAL, AFTER DECEMBER 31, 1985 UNITS OF STATE OR LOCAL GOVERNMENT WILL BE REQUIRED TO MAKE A FINANCIAL CONTRIBUTION EQUIVALENT TO 1% OF THE FACE VALUE OF THE BONDS TO EACH CAPITAL PROJECT FOR WHICH THEY ISSUE PRIVATE PURPOSE TAX-EXEMPT BONDS. THE CONTRIBUTION CAN TAKE THE FORM OF A CASH PAYMENT, TAX CREDIT OR ABATEMENT, OR PROVISION OF ADDITIONAL SERVICES. THE TREASURY DEPARTMENT, IN DOCUMENTS RELEASED FEBRUARY 26, 1982, DID INDICATE THAT THE GENERAL TAX EXEMPTIONS PROVIDED FOR EXEMPT ORGANIZATIONS UNDER STATE LAW COULD BE USED TO SATISFY THE CONTRIBUTION REQUIREMENT WITH RESPECT TO PROJECTS FOR EXEMPT ORGANIZATIONS.

THE RAMIFICATIONS OF THE IMPLEMENTATION OF THIS ASPECT OF THE ADMINISTRATION'S PROPOSAL COULD BE ABSOLUTELY DEVASTATING TO NOT-FOR-PROFIT HOSPITALS IF GENERAL TAX EXEMPTIONS UNDER STATE LAW ARE NOT ALLOWED TO SATISFY THE FINANCIAL CONTRIBUTION REQUIREMENT.

UNITS OF STATE, COUNTY AND MUNICIPAL GOVERNMENT AT THIS TIME AND FOR THE FORESEEABLE FUTURE ARE NOT IN THE FINANCIAL POSITION TO MAKE SUCH CONTRIBUTIONS. IN ADDITION, MANY STATE GOVERNMENTS, AND THEREFORE COUNTY AND LOCAL GOVERNMENTS, ARE CONSTITUTIONALLY PROHIBITED FROM MAKING CONTRIBUTIONS TO INSTITUTIONS WITH RELIGIOUS SPONSORS. FOR ALL INTENTS AND PURPOSES, TAX-EXEMPT FINANCING WILL CEASE TO BE AN AVENUE TO CAPITAL FOR NOT-FOR-PROFIT HEALTH FACILITIES EVEN THOUGH THESE HOSPITALS SERVE A PUBLIC PURPOSE.

IF TAX-EXEMPT BONDS CEASE TO BE AN AVENUE TO CAPITAL, HEALTH FACILITIES MUST USE TAXABLE BONDS. FOR MANY HOSPITALS, SUCH A PROPOSAL COULD THREATEN THEIR EXISTENCE.

- PRIVATE, NOT-FOR-PROFIT HOSPITALS IN THE INNER CITY WHICH HAVE A HIGH VOLUME OF MEDICARE, MEDICAID AND CHARITY PATIENTS PERFORM A PUBLIC SERVICE TO SUCH AN EXTENT THAT STATE, COUNTY AND/OR MUNICIPAL HOSPITALS COULD NOT PICK UP THAT LOAD IF THESE HOSPITALS WERE TO DISAPPEAR.
- HOSPITALS THAT SERVE A HIGH POPULATION OF MEDICARE, MEDICAID AND CHARITY PATIENTS TEND TO BE WEAKER HOSPITALS FINANCIALLY BECAUSE OF THE DISCOUNT ENJOYED BY THE MEDICARE AND MEDICAID PROGRAMS.
- BECAUSE OF THEIR WEAKER FINANCIAL CONDITION, THESE HOSPITALS WILL BE UNABLE TO COMPETE EFFECTIVELY FOR CAPITAL IN THE TAXABLE BOND MARKET.
- WITHOUT ACCESS TO CAPITAL, THEIR VERY EXISTENCE IS THREATENED.

FOR HOSPITALS THAT CAN COMPETE EFFECTIVELY IN THE TAXABLE BOND MARKET, SUCH A MOVE MEANS MORE EXPENSIVE HEALTH CARE:

- HOSPITALS THAT ARE ABLE TO FLOAT TAXABLE BONDS WILL HAVE TO PASS ON THE INCREASED COSTS OF TAXABLE FINANCING TO THE PATIENTS AND THEIR PAYORS.
- FOR EMPLOYERS AND EMPLOYEES, THIS MEANS SUBSTANTIAL INCREASES IN INSURANCE PREMIUMS AND THEREFORE INCREASES IN THE COST OF PRODUCTS THEY PRODUCE.
- FOR GOVERNMENT, THIS MEANS INCREASED PAYOUT FOR THE HEALTH INSURANCE PREMIUMS OF FEDERAL EMPLOYEES UNDER BOTH FHEP FOR CIVILIAN EMPLOYEES AND CHAMPUS FOR MILITARY EMPLOYEES, RETIREES AND THEIR DEPENDENTS. IT ALSO MEANS INCREASED PAYOUT IN THE FORM OF MEDICARE AND MEDICAID AND INCREASED COSTS FOR ALMOST EVERY GOOD OR SERVICE PURCHASED BY THE GOVERNMENT.

TAX-EXEMPT FINANCING FOR TAX-EXEMPT HEALTH CARE FACILITIES SHOULD REMAIN A REALITY

IN THIS SECTION OF OUR TESTIMONY WE WILL SEEK TO MAKE THE CASE THAT:

1. THERE ARE NO HEALTH POLICY CONSIDERATIONS WHICH WOULD PROVIDE SUFFICIENT JUSTIFICATION TO WARRANT RESTRICTING OR ELIMINATING ACCESS TO TAX-EXEMPT FINANCING ON THE PART OF NOT-FOR-PROFIT HEALTH CARE FACILITIES.
2. THERE ARE A NUMBER OF HEALTH POLICY CONSIDERATIONS WHICH WOULD MORE THAN JUSTIFY PRESERVING ACCESS TO TAX-EXEMPT CAPITAL FINANCING FOR NOT-FOR-PROFIT HEALTH CARE FACILITIES.

...NO NEED TO RESTRICT OR ELIMINATE ACCESS TO TAX-EXEMPT FINANCING...:

THIS SECTION WILL ADDRESS TWO ARGUMENTS THAT HAVE BEEN OFFERED IN SUPPORT OF RESTRICTING OR ELIMINATING ACCESS TO TAX-EXEMPT FINANCING FOR NOT-FOR-PROFIT HOSPITALS:

- OVERBEDDING

- TAX-EXEMPT FINANCING IS AN INEFFICIENT WAY TO SUBSIDIZE HOSPITAL CONSTRUCTION

OVERBEDDING: THE MAIN ARGUMENT IN THE OVERBEDDING AREA IS THAT THERE IS TOO MUCH HOSPITAL CAPACITY IN THE COUNTRY AS A WHOLE. THE MOST GRAPHIC ILLUSTRATION OF THIS POINT WAS MADE WITH RESPECT TO HOSPITAL BEDS WHEN THE BUREAU OF HEALTH PLANNING SET THE 4.0 BEDS PER 1,000 POPULATION. THERE MAY BE AREAS OR LOCALITIES THAT HAVE AN EXCESS OF HOSPITAL CAPACITY, BUT RESTRICTING OR ELIMINATING HOSPITAL ACCESS TO TAX-EXEMPT CAPITAL FINANCING TO CURE THAT PERCEIVED EVIL, IF IT DOES EXIST, IS AN OVERKILL SOLUTION TO THE PROBLEM.

TO BE SURE, SOME TAX-EXEMPT FINANCING MAY BE USED TO FINANCE NEW CONSTRUCTION OF HOSPITALS, BUT MUCH MORE HAS BEEN USED TO ADD NEW SERVICES, REFINANCE EXISTING DEBT, AND RENOVATE EXISTING FACILITIES. HOSPITALS REFINANCE THEIR DEBT FOR A VARIETY OF REASONS, ALL OF WHICH RESULT IN EITHER A STRONGER FINANCIAL POSITION FOR THE HOSPITAL OR A REDUCTION IN COSTS. HOSPITALS WILL CONTINUE TO NEED TO RENOVATE THEIR FACILITIES AS THEIR PHYSICIAL PLANTS BEGIN TO WEAR OUT AND FAIL BUILDING, LIFE SAFETY AND FIRE CODES.

ESTIMATES OF THE AMOUNT OF CAPITAL WHICH WILL BE NEEDED BY HOSPITALS IN THE 1980S RANGE FROM $130 BILLION TO $190 BILLION; AND AS IN THE PAST, A MAJOR PORTION, 70-80%, OF THAT CAPITAL WILL REFINANCE EXISTING DEBT OR RENOVATE EXISTING FACILITIES. THE APPROPRIATE QUESTION TO BE ASKED IS:

DOES THIS COUNTRY WANT TO RAISE THE COST OF HEALTH CARE IN THE '80S, '90S AND BEYOND BY THE INCREASED INTEREST NECESSARY ON TAXABLE FINANCING, JUST TO CURE AN OVERBEDDING PROBLEM WHICH MAY OR MAY NOT BE A REALITY?

TAX-EXEMPT FINANCING IS AN INEFFICIENT WAY TO SUBSIDIZE HOSPITAL CONSTRUCTION: ONE OF THE ARGUMENTS IN THIS AREA IS THAT MUCH OF THE SUBSIDY ASSOCIATED WITH TAX-EXEMPT FINANCING, AS MUCH AS ONE-THIRD, GOES TO BOND HOLDERS, UNDERWRITERS AND BOND COUNSEL.

PROPONENTS OF THE INEFFICIENCY ARGUMENT SUGGEST THAT WITH DIRECT SUBSIDIES, LIKE A HILL-BURTON PROGRAM, 100% OF THE SUBSIDY WOULD GO TO THE INSTITUTION. HOWEVER, DIRECT SUBSIDIES AT THE NATIONAL LEVEL WOULD REQUIRE BOTH A SIZEABLE BUDGET AND A SIZEABLE FEDERAL BUREAUCRACY TO IMPLEMENT THE PROGRAM. SUCH AN EFFORT WOULD BE INCONSISTENT WITH THE REAGAN ADMINISTRATION'S OBJECTIVE OF REDUCING THE SIZE OF GOVERNMENT AND COULD BE MORE EXPENSIVE THAN THE PRESENT TAX-EXEMPT FINANCING MECHANISM.

...JUSTIFICATION FOR PRESERVING ACCESS TO TAX-EXEMPT FINANCING...

FOR A NUMBER OF REASONS, TAX-EXEMPT FINANCING IS AND SHOULD REMAIN AN INTEGRAL PART OF THE FINANCING OF NOT-FOR-PROFIT HEALTH CARE FACILITIES. THESE REASONS REVOLVE AROUND THE FOLLOWING CONSIDERATIONS:

- PUBLIC PURPOSE OF NOT-FOR-PROFIT HOSPITALS;
- MAGNITUDE OF THE NEED FOR CAPITAL;
- CONSEQUENCES OF SEEKING TAXABLE FINANCING;
- PROBLEMS ASSOCIATED WITH CURRENT GOVERNMENT REIMBURSEMENT POLICY;

- POTENTIAL DISADVANTAGE OF NOT-FOR-PROFIT HOSPITALS VIS-A-VIS THEIR FOR-PROFIT COUNTERPARTS.

PUBLIC PURPOSE OF NOT-FOR-PROFIT HOSPITALS: NOT-FOR-PROFIT HOSPITALS UNQUESTIONABLY SERVE A PUBLIC PURPOSE, AN ESSENTIAL PUBLIC PURPOSE AS ACUTE CARE HEALTH FACILITIES ESTABLISHED BY UNITS OF STATE, COUNTY AND CITY GOVERNMENTS. THEY SERVE THE GENERAL PUBLIC AS WELL AS PATIENTS WHO ARE BENEFICIARIES OF GOVERNMENT PROGRAMS LIKE MEDICARE AND MEDICAID AND THE INDIGENT AND MEDICALLY INDIGENT IN THE COMMUNITY.

IN ALMOST EVERY LARGE INNER CITY IN THE COUNTRY THERE ARE NOT-FOR-PROFIT HOSPITALS WHOSE PATIENT LOADS ARE PRIMARILY MEDICARE, MEDICAID, AND THE POOR. THESE HOSPITALS ARE, IN MOST INSTANCES, RELATIVELY WEAK FINANCIALLY BOTH BECAUSE OF THE INADEQUACIES OF THE MEDICARE AND MEDICAID REIMBURSEMENT MECHANISM AND BECAUSE OF THEIR HIGH CHARITY LOAD. IF WELL MANAGED, THESE HOSPITALS CURRENTLY RECEIVE BBB RATINGS ON THEIR TAX-EXEMPT BONDS.

FREQUENTLY THESE HOSPITALS ARE OLDER FACILITIES, BUILT EARLY IN THIS CENTURY AND IN THE NEAR FUTURE WILL BE AMONG THE FIRST TO ATTEMPT TO RAISE CAPITAL TO RENOVATE OR REPLACE THEIR WORN OUT PHYSICAL PLANTS. IF TAX-EXEMPT FINANCING IS RESTRICTED OR ELIMINATED AS A RESULT OF IMPLEMENTING THE ADMINISTRATION'S TAX-EXEMPT BOND PROPOSAL, MANY OF THESE HOSPITALS WILL BE ELIMINATED FROM THE TAXABLE BOND MARKET. BECAUSE OF THEIR RELATIVELY WEAK FINANCIAL CONDITIONS, BOND RATING AGENCIES ARE LIKELY TO GIVE THESE HOSPITALS' TAXABLE BONDS A BB RATING, A RATING WHICH IS NOT HIGHLY SALABLE.

IF THESE HOSPITALS FAIL BECAUSE THEIR WORN OUT PHYSICAL PLANTS CANNOT PASS BUILDING, FIRE AND LIFE SAFETY CODES AND BECAUSE THEY CANNOT OBTAIN THE CAPITAL NECESSARY TO RENOVATE OR REPLACE THEIR PHYSICAL PLANT, WHO WILL PICK UP THEIR PATIENT LOAD? THERE ARE NOT ENOUGH PUBLIC HOSPITALS TO FULFILL SUCH AN EXPANDED NEED.

NOT-FOR-PROFIT HOSPITALS ARE NOT MERELY PUBLIC PURPOSE, AS A PARK IS PUBLIC PURPOSE. THEY ARE ESSENTIAL PUBLIC PURPOSE ENTITIES.

HOSPITAL CAPITAL NEEDS IN 1980S - $130-190 BILLION. CONSEQUENCES OF SEEKING TAXABLE FINANCING: ESTIMATES OF THE AMOUNTS OF CAPITAL WHICH WILL BE NEEDED BY HOSPITALS IN THE 1980S RANGE FROM $130 BILLION TO $190 BILLION. IF TAX-EXEMPT FINANCING IS RESTRICTED OR ELIMINATED AS A RESULT OF THE ADMINISTRATION'S PROPOSAL, FINANCIALLY SOUND HOSPITALS WILL RAISE CAPITAL THROUGH TAXABLE BONDS. INTEREST RATES ON TAXABLE AND TAX-EXEMPT BONDS HAVE NARROWED IN RECENT YEARS BUT THERE IS A DIFFERENCE. INTEREST ON TAXABLE BONDS IS GENERALLY 3-5% HIGHER THAN INTEREST ON TAX-EXEMPT BONDS. IF HOSPITALS ARE FORCED INTO THE TAXABLE BOND MARKET, THEY ARE LIKELY TO HAVE TO PAY ADDITIONAL INTEREST EQUAL TO 50% OF THE PRINCIPAL.

A SEARCH FOR TAXABLE FINANCING ALSO PRESENTS OTHER PROBLEMS FOR HOSPITALS. BY AND LARGE THE LENGTH OF A TAXABLE FINANCING IS CONSIDERABLY SHORTER THAN THE LIFE OF THE ASSET AS RECOGNIZED BY MEDICARE. FOR INSTANCE, IF A HOSPITAL USES TAXABLE FINANCING

TO REPLACE ITS PHYSICAL PLANT, IT MAY HAVE TO PAY OFF THE LOAN OVER A TEN OR FIFTEEN YEAR PERIOD. HOWEVER, MEDICARE WILL REQUIRE THE LIFE OF THE ASSET TO BE 20 OR MORE YEARS AND REIMBURSE DEPRECIATION OVER THE 20-YEAR PERIOD. HAVING TO RETIRE THE DEBT FASTER THAN THE DEPRECIATION SCHEDULE RECOGNIZED BY MEDICARE WILL ONLY ERODE FURTHER THE FINANCIAL VIABILITY OF HOSPITALS.

FURTHERMORE, IF HOSPITALS ARE FORCED INTO THE TAXABLE BOND MARKET, THAT MEANS HIGHER INTEREST PAYMENTS FOR HOSPITALS AND A HIGHER COST OF MEDICAL CARE. HOSPITALS THAT GO FOR TAXABLE FINANCING WILL HAVE TO PASS THIS INCREASED COST TO INSURERS. INSURERS WILL IN TURN PASS THIS ALONG TO EMPLOYERS WHO PAY FOR EMPLOYEE HEALTH BENEFITS. THE COST OF PRODUCTION OF GOODS AND SERVICES WILL IN TURN INCREASE GENERALLY. THIS WILL RESULT IN HIGHER PRICES FOR GOVERNMENT AND THE PUBLIC IN GENERAL AS THEY PURCHASE GOODS AND SERVICES FROM THE PRIVATE SECTOR.

ABILITY OF NOT-FOR-PROFIT HOSPITALS TO RAISE CAPITAL IS IMPAIRED BY FEDERAL TAX AND MEDICARE/MEDICAID REIMBURSEMENT POLICY: PRIVATE, NOT-FOR-PROFIT HOSPITALS CANNOT RAISE EQUITY CAPITAL (I.E., ISSUE STOCK). TO RAISE CAPITAL, NOT-FOR-PROFIT HOSPITALS MUST RELY ON CHARITABLE CONTRIBUTIONS, EARNINGS ACCUMULATION OR DEBT FINANCING.

- CHARITABLE GIVING OR PHILANTHROPY HAS BEEN DECLINING AS A SOURCE OF CAPITAL FOR THE POPULATION OF HOSPITALS AS A WHOLE. AT THE CLOSE OF THE 1970S, PHILANTHROPY ACCOUNTED FOR APPROXIMATELY 2% OF THE TOTAL SOURCES OF HOSPITAL CAPITAL. IN ADDITION, CHARITABLE CONTRIBUTIONS, INCLUDING THOSE MADE TO NOT-FOR-PROFIT HOSPITALS, ARE PREDICTED TO DECLINE AS A RESULT OF THE DIMINISHED

INCENTIVE TO MAKE SUCH CONTRIBUTIONS WITH THE PHASE-IN OF THE TAX RATE REDUCTIONS ENACTED IN 1981.

- EARNINGS ACCUMULATION OCCURS WHEN REVENUES EXCEED THE COSTS OF DELIVERING MEDICAL CARE. MEDICARE AND MEDICAID CREATE A SERIOUS PROBLEM IN THIS AREA. ALTHOUGH MEDICARE IS ALLEGED TO PAY FOR THE "REASONABLE COST" OF DELIVERING MEDICAL CARE IN INSTITUTIONAL SETTINGS, THERE ARE SEVERAL COSTS THAT ARE NOT RECOGNIZED BY MEDICARE AS ALLOWABLE. SUCH COSTS WOULD INCLUDE RETURN ON EQUITY FOR NOT-FOR-PROFIT FACILITIES. IT IS GENERALLY BELIEVED THAT THE SHORTFALL IN MEDICARE REIMBURSEMENT DUE TO NON-RECOGNITION OF SUCH COSTS IS 15-20%. UNDER THE MEDICAID PROGRAM THE SHORTFALL IS ESTIMATED TO BE AS MUCH AS 30% IN SOME INSTANCES. WHEN THE MEDICARE/MEDICAID REIMBURSEMENT PROVISIONS OF THE OMNIBUS RECONCILIATION ACTS OF 1980 AND 1981 ARE IMPLEMENTED, THE SHORTFALLS WILL GROW EVEN LARGER.

  MEDICARE AND MEDICAID DO REIMBURSE FOR DEPRECIATION BASED ON THE HISTORICAL COST OF THE ASSET. HOWEVER, IF A HOSPITAL FUNDS ITS DEPRECIATION, THE DOLLAR AMOUNT IN THE FUNDED DEPRECIATION ACCOUNT AT THE END OF THE DEPRECIATION SCHEDULE IS THE ORIGINAL PRICE OF THE ASSET AT PURCHASE. INFLATION IN THE INTERVENING YEARS WILL CAUSE THE REPLACEMENT COST OF THE ASSET TO BE SUBSTANTIALLY MORE THAN THE ACCUMULATED DEPRECIATION.

  NOT ONLY DO MEDICARE AND MEDICAID NOT CONTRIBUTE TO EARNINGS ACCUMULATION BUT THEIR REIMBURSEMENT POLICIES ALSO TEND TO WEAKEN HOSPITALS FINANCIALLY. THE MORE MEDICARE AND MEDICAID PATIENTS WHICH A HOSPITAL TREATS, THE MORE IT TENDS TO ERODE ITS CAPITAL BASE.

THIS PROPOSAL COULD HAVE A MAJOR IMPACT ON THE VIABILITY OF

NOT-FOR-PROFIT HOSPITALS VIS-A-VIS THEIR INVESTOR-OWNED, FOR-PROFIT HOSPITAL COUNTERPARTS: SINCE THE ADVENT OF MEDICARE AND MEDICAID, THE INVESTOR-OWNED HOSPITAL HAS BECOME A LARGE AND GROWING PART OF THE TOTAL HOSPITAL SECTOR. THESE INVESTOR-OWNED HOSPITALS COMPETE WITH NOT-FOR-PROFIT HOSPITALS FOR DOCTORS, PATIENTS AND CAPITAL. BY RAISING THIS POINT CHA DOES NOT MEAN TO SPEAK AGAINST FOR-PROFIT HOSPITALS OR THE COMPETITION THEY BRING TO THE HEALTH CARE SECTOR. WE DO MEAN TO SAY, HOWEVER, THAT FEDERAL POLICIES THAT WOULD AFFECT EITHER THE FOR-PROFIT OR THE NOT-FOR-PROFIT FACILITY, DIRECTLY OR INDIRECTLY, SHOULD NOT BE ADVOCATED OR IMPLEMENTED WITHOUT TAKING INTO CONSIDERATION THE EFFECT OF THE PROPOSAL ON THE ABILITY OF EACH SECTOR OF THE INDUSTRY TO COMPETE WITH THE OTHER. THAT IS, THE GOVERNMENT SHOULD PROVIDE NEITHER ADVANTAGE NOR DISADVANTAGE TO EITHER SECTOR AS A RESULT OF ITS POLICIES.

WITH RESPECT TO ACCESS TO CAPITAL THE NOT-FOR-PROFIT HOSPITAL IS ALREADY WIDELY VIEWED AS BEING AT A SERIOUS DISADVANTAGE TO ITS INVESTOR-OWNED COUNTERPART. WHILE REDUCED PHILANTHROPY AND GOVERNMENT REIMBURSEMENT POLICIES JEOPARDIZE THE FINANCIAL STRENGTH AND THUS, THE INVESTMENT APPEAL, OF NOT-FOR-PROFIT HOSPITALS, THE FOR-PROFIT HOSPITAL INDUSTRY SIMPLY ISSUES MORE STOCK IN WHAT IS, AT THE PRESENT TIME, A STRONG GROWTH SECTOR OF THE MARKET. TWO FACETS OF THIS ADMINISTRATION'S PROPOSAL WOULD ADD SIGNIFICANTLY TO THE PRESENT DISADVANTAGE OF NOT-FOR-PROFIT FACILITIES.

FIRST OF ALL, THE PUBLIC HEARING AND APPROVAL PROCESS OF TAX-EXEMPT FINANCING IS A PROCESS TO WHICH THE FOR-PROFIT HOSPITAL WOULD NOT BE SUBJECT SINCE IT DOES NOT ORDINARILY SEEK SUCH FINANCING. IN ADDITION, SUCH A PROCESS WOULD CREATE A BOTTLENECK AT THE GOVERNOR'S OFFICE IN MANY STATES AND IN SO DOING, ADD TO THE COST OF THE PROJECT BY DELAYING CONSTRUCTION.

THE FINANCIAL CONTRIBUTION REQUIREMENT, IF IMPLEMENTED WITHOUT SPECIAL CONSIDERATION FOR TAX-EXEMPT ORGANIZATIONS, WOULD ELIMINATE ALMOST ALL ACCESS TO TAX-EXEMPT FINANCING, PARTICULARLY FOR THOSE HOSPITALS THAT SERVE HIGH PROPORTIONS OF MEDICARE/MEDICAID AND CHARITY PATIENTS. SUCH A PROPOSAL WOULD SIMPLY ELIMINATE THEIR ACCESS TO CAPITAL.

SUMMARY AND RECOMMENDATION

IN SUM, CHA FINDS THAT THE ADMINISTRATION'S ARGUMENT THAT TAX-EXEMPT BONDS ISSUED FOR PRIVATE PURPOSE

- CAUSE HIGHER INTEREST RATES FOR STATE AND LOCAL FINANCINGS, AND
- CAUSE REVENUE LOSS TO THE FEDERAL TREASURY

DOES NOT STAND UP WHEN VIEWED IN THE CONTEXT OF TAX-EXEMPT CAPITAL FINANCING FOR NOT-FOR-PROFIT HOSPITALS.

FURTHERMORE, THERE APPEARS TO BE NO HEALTH POLICY CONSIDERATION WHICH WOULD PROVIDE SUFFICIENT JUSTIFICATION TO WARRANT RESTRICTING ACCESS TO TAX-EXEMPT FINANCING ON THE PART OF NOT-FOR-PROFIT HOSPITALS. ON THE CONTRARY, THERE ARE SEVERAL HEALTH POLICY CONSIDERATIONS WHICH WOULD MORE THAN JUSTIFY PRESERVING

ACCESS TO TAX-EXEMPT FINANCING ON THE PART OF NOT-FOR-PROFIT HEALTH CARE FACILITIES, FACILITIES WHICH SERVE AN ESSENTIAL PUBLIC PURPOSE.

CHA RECOMMENDS THAT IF THE CONGRESS FEELS COMPELLED TO MODIFY THE STATUTE WITH RESPECT TO TAX-EXEMPT FINANCING FOR PRIVATE PURPOSES THAT SUCH MODIFICATIONS NOT APPLY TO EXEMPT ORGANIZATIONS (NOT-FOR-PROFIT HOSPITALS) AS DESCRIBED IN 103(B)(3) OF THE STATUTE.

Mr. **Rangel**. Thank you, Monsignor.

Karl Zeisler.

STATEMENT OF KARL ZEISLER, VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, RUSH-PRESBYTERIAN-ST. LUKE'S MEDICAL CENTER, CHICAGO, ILL.

Mr. **Zeisler**. Members of the Ways and Means Committee, thank you for inviting me to brave a blizzard and appear before you today.

I am Karl Zeisler, the vice president-finance and chief financial officer of Rush-Presbyterian-St. Luke's Medical Center, a major multihospital academic medical center and health sciences university, located principally near downtown Chicago.

I ask——

Mr. **Russo**. Let me interrupt. It is also located about 2 blocks from where I was born and raised.

Mr. **Zeisler**. Where Congressman Russo was born and raised.

Mr. **Rangel**. I don't know whether that is going to help.

Mr. **Zeisler**. Him or us, Congressman?

Mr. **Rangel**. I am glad it is on the record, though.

Mr. **Zeisler**. I ask that my written statement be accepted for the record.

Mr. **Rangel**. Let me take time out to say for all of the witnesses, that your full statements will be entered into the record, and the record will remain open until the end of the week, in case you decide to give additional testimony.

Mr. **Zeisler**. On behalf of all of us, thank you.

I hope in these next few minutes to provide you with an opportunity to focus with me on just a few points which I believe are the most crucial to your recognition of the issue before us:

Curtailment of access, on the part of universities and hospitals, to tax-exempt capital markets, based upon your legitimate concerns over the tax expenditures impact.

Private, not-for-profit universities and hospitals long have been viewed by you, and by most Americans, as public purpose institutions. We work alongside sister public institutions. We have been afforded tax-exempt borrowing, relief from taxes on endowment income, exemption from real estate and sales taxes and the like.

All of these legislative sanctions have been essential elements in the survival of our system; they are the public's surrogates for the profit incentive in the eduction of the young and the treatment of the ill of our country.

In the past 5 to 10 years, record-high inflation, new technology in diagnosis and treatment and declining philanthropy fueled by changes in tax laws, a weak economy and weak securities markets, all have put growing pressure on hospitals and universities to borrow to meet essentially mandated capital needs.

At the same time, we Americans have discouraged our local governments from building buildings, roads, or bridges. We have said, "Don't tax us, don't borrow if you have to tax us to pay the interest and principal."

Thus, hospitals' and universities' share of tax-exempt debt rose, although the substantial new tax expenditures coming from tax-exempt financing has indeed been for the relatively new industrial development bonds about which you heard more earlier this morning.

They represent a purported stimulant to new jobs. That is a different economic and social sanction than the private, not-for-profit hospitals and universities have enjoyed for essentially the entire 200-plus years of existence of our society.

To send us, the private, not-for-profit hospitals and universities, to the taxable capital market, which is dominated by for-profit corporations is clearly a profound change in circumstance.

That market, the taxable market, itself, appears to be in the midst of a major restructuring, one which is clearly adverse to the interest of not-for-profit borrowers. It is going to become more selective and more difficult as has been alluded to by the monsignor a few minutes earlier for less than the most superb credits to successfully have access to that market, which indeed would be the only market available if the proposed actions are implemented.

To ask not-for-profit hospitals and universities to seek their capital in that market in the future is a death knell for most of the affected institutions.

Given the nature and magnitude of other pressures upon higher education and health care in these difficult times, the probability of little or no access to capital markets will surely produce crises, in which governments—a crisis we believe will ultimately be taken by Federal Government, a costly role before the predictable outcomes emerge.

Private, not-for-profit universities and hospitals will survive, but probably weakened and with some additional cost to the public.

Tax expenditures deserve now, as always, close scrutiny by this Congress and the administration. But the premise cannot be that all are evil, none are worthy. Congress and the administration have information which directs attention to the ills, and appropriate specific remedies are known.

We ask that you preserve that which has been a cherished, valuable and effective tradition, the recognition that private, not-for-profit hospitals and universities indeed do well serve important public purposes, and accordingly deserve the preservation of key sanctions, including that on which we are focusing today, broad access to tax-exempt capital markets for the small institutions as well as the very large, for the rural as well as the urban, for the weakened and dedicated providers as well as for the rest of us.

As a matter of fact, to illustrate the role which tax expenditures can play, one possible example is a preference for a tax expenditure approach over a budget expenditure approach in the student loan financing arena.

There are many of us who believe sincerely and have good evidence to prove that tax-exempt private funding of student loans offers substantial advantages over the costly ineffective direct Federal subsidies which we have all been keenly aware of during the past decade.

In closing, let me point out that last year, I was honored by my peers with a national award—a first, a sign of the times, and we think times coming. It was for cost containment through a new form of borrowing at an interest cost at about 60 percent of the level of interest costs of conventional long-term, tax-exempt bonds.

We believe that is what you and all Americans want to see happening in health care and higher education as in every sector of our society.

The opportunities and incentives to do more of this flow from the legislative framework; give us access, but challenge us to perform and to be cost effective. We can and we will, with your encouragement and support.

I thank you for your attention.

[The prepared statement follows:]

STATEMENT OF KARL ZEISLER, VICE PRESIDENT-FINANCE AND CHIEF FINANCIAL OFFICER OF RUSH-PRESBYTERIAN-ST. LUKE'S MEDICAL CENTER, CHICAGO, ILL.

My name is Karl Zeisler. I am the Vice President-Finance and Chief Financial Officer of Rush-Presbyterian-St. Luke's Medical Center, a major academic medical center and health sciences university located a few minutes from downtown Chicago. From 1976 until recently, I held the same position at Loyola University of Chicago, the largest private university in Illinois.

It is a privilege to have the opportunity to present these views to the members of the House Committee on Ways and Means as you consider Administration proposals which would limit or alter the access to capital markets for private not-for-profit hospitals and universities, which have long-standing traditions of serving public purposes along with their sister public institutions throughout the nation. At issue is the matter of the current public interest in "tax expenditures" and the interdependency of such tax expenditures with other federal budget matters, most notably the Medicare and Medicaid programs. Rather than reviewing all of the issues which have been raised and effectively articulated by many parties interested in all sides of these issues, I would like to briefly summarize the pros and cons from each major vantage point, i.e. the federal government, investors in relevant securities, and the ultimate issuers--private, not-for-profit hospitals and universities.

First of all, from the point of view of the federal government, rapid increases in the total amount of tax-exempt bond financing in recent years may well justify examination of curtailment proposals, but these should be directed at the sources and causes of the abuses, which overwhelmingly fall into the category of industrial development bonds, especially small issues. Recent record high levels of unemployment certainly lead one to question any effective stimulative role played by that form of financing, such as it was intended to provide.

Because of substantial availability of alternative tax-exempt or tax-sheltered investment vehicles, if the opportunity to invest in tax-exempt bonds were sharply curtailed, investors presently would find alternative investments which would cause the federal government to face equivalent or greater tax expenditures. Most relevant to the federal government, however, is the fact that any curtailment of investment in hospital tax-exempt bonds is likely to produce a substantial, immediate, adverse impact upon the federal budget due to two effects upon the Medicare and Medicaid programs: (1) the need to reimburse higher interest costs resulting from the curtailment, and (2) the reimbursement impact of required refinancings, flowing from the inability to meet debt-service covenants on currently outstanding tax-exempt bond issues. This shift in financing activity, with its adverse budgetary impact upon the federal government, would likely be exacerbated by a number of factors, e.g. inability of the capital market to effectively regulate capital expenditures in the health care industry, the excessive rate of inflation in hospital construction costs, and the emerging need to no longer defer repairs and renovation of facilities. The availability of, and addiction to, new diagnosis and treatment technology produces a growing need for capital, even absent inflation. This is accompanied by a reduction in philanthropy, stemming from changes in tax laws and adverse economic and securities market conditions, along with declining resources generated from operations. This is due principally to the impact of inflation on wages, salaries and benefit costs in these exceptionally labor-intensive public purpose enterprises; human resources account for about two-thirds of the cost of private higher education and health care.

Similarly, student loans funded with tax-exempt capital represent a new, appropriate, substitute for an existing expensive and ineffective subsidization via the federal budget, as well as a model example of a situation in which tax-exempt financing may be superior and more effective than federal budget line items.

In summary, private, not-for-profit hospitals and universities which have long served public purposes alongside sister public institutions, and the long-standing tradition of tax-exempt financing as well as many other public sanctions, should be preserved when none of the abuse which is of legitimate concern to this Congress can be attributed to those sectors of our society. Just as the abuses may be principally with industrial development bonds, the growth in housing subsidy bonds must be seen as a legislative incentive, not as an abuse, for it was done through the initiative of this Congress, in order to seek to stimulate a severely depressed housing market through relief from unconscionably high mortgage interest rates.

There is an emerging short-term tax-exempt bond market in which investors in high tax brackets continue to show strong interest, purchasing tax-exempt securities at interest rates which have been consistently below 50% of the comparable taxable interest rates. This more effective use of tax expenditures bears witness to the fact that hospitals, universities and other tax-exempt borrowers are concerned about both the net budgetary impact upon the federal government and the cost of health care delivery, higher education and other public purpose services.

In examining the increase in the share of tax-exempt borrowing attributable to hospitals and universities, one should recall that municipalities have been under contrary pressures in recent years, and moreover are not subject to the same facilities compliance and standards with respect to buildings, roads and bridges as are the nation's hospitals.

Investors who might be denied their traditional preferences for tax-exempt bonds are not likely to invest in comparable taxable securities, thereby providing federal tax revenues, so long as other tax-exempt or tax-deferring vehicles remain available and attractive. So to be truly effective, any initiative to curtail tax-exempt debt financing must be accompanied by substantial restrictive changes in the tax laws; these changes do not appear to us to be imminent in the Administration's programs. What would more likely happen is that hospitals and universities would be forced to compete with traditional, for-profit, taxable borrowers in a market into which no substantial new investors would be forced--and to attract them would indeed be costly. For example, might not hospitals and universities be forced to compete in the debt market with public utilities in a contest in which the hospitals and universities would be forced to pay the very highest interest rates if they could finance at all? Thus, the concern for tax expenditures must be weighed in the context of encouraging stable and effective capital formation markets and processes for public purpose institutions, such as private not-for-profit universities and hospitals.

From the point of view of hospitals, reduced access to capital markets and/or higher borrowing costs, perhaps unfortunately, does not curtail spending. Spending is driven not by expansion of bed capacity, which is regulated and essentially static, but rather by a combination of rising standards for facilities and the growth of new technologies in diagnosis and treatment. But the costs of borrowing are driven by external market forces, which function partly on the basis of the credit worthiness of borrowers. Private, not-for-profit hospitals are not well positioned to effectively compete with corporate issuers in the debt markets. Universities are similarly threatened by the prospects of such probably unsuccessful competition. To potentially weaken the physical plant of these establishments increases the prospects of even greater future public tax burdens for educating the population and treating its ill.

Because of the substantial cost-based reimbursement to hospitals by Medicare, Medicaid and some non-government insurers, increasing the cost of capital represents a further direct increase in reimbursement. Hospitals cannot absorb such cost increases; there are no owners or stockholders available to absorb higher costs, no philanthropists to do so; patients, citizens and major employers who pay for health care primarily through taxes and group insurance premiums will pay. Can we afford this? Can Congress afford to cause some of that cost burden to shift, especially when one of the largest shifts would be from tax expenditures to the Medicare line in the federal budget? The proposed change is neither an effective capital rationing mechanism nor a cost-effective change in the important and sizeable federal support of health care for the aged and the poor.

During the past two years the tax-exempt bond market, like its parallel taxable bond market, has undergone unprecedented changes, most notably in interest rate levels. It has been suggested that one impact in need of correction by Congress is in tax expenditure per dollar of hospital interest cost savings. What is emerging of note, however, is lower-cost, historically unprecedented effective borrowing in new short-term tax-exempt markets. While conventional long-term tax-exempt bond interest rates have moved from 50% to 70% of comparable taxable rates, due in part to recent permanent changes in tax laws, these new short-term tax-exempt securities have consistently carried interest rates at 50% or less of comparable taxable short-term interest rates. One reason is clearly the desire on the part of universities and hospitals to contain capital costs as they grow in relative importance. We urge this Committee, this Congress and the Administration to recognize its potential role in offering new and greater incentives to these public purpose institutions to continue to provide necessary services and, at the same time, undertake new efforts to be increasingly cost-effective.

Both higher education and health care have been at crucial crossroads in our society in recent years. As our trustees and managements move with deliberate speed toward the kinds of responsible decisions and actions which all Americans would be proud of, we need the understanding, support and encouragement of government. We know that you will agree and that you will demonstrate that understanding, support and encouragement, by preserving the long-standing and rational recognition of the public-purpose character of the nation's private, not-for-profit hospitals and universities.

Thank you.

Mr. RANGEL. Thank you.

Mr. Anthony Taddey, chairman of the Health Care Financing Study Group.

STATEMENT OF ANTHONY J. TADDEY, CHAIRMAN, HEALTH CARE FINANCING STUDY GROUP

Mr. TADDEY. Mr. Chairman, my name is Anthony J. Taddey, and I am the managing director of the Health Care Finance Group at Merrill Lynch White Weld. I am speaking today in my capacity as chairman of the Health Care Financing Study Group, a national association of investment banking, law, and accounting firms involved in providing capital financing for health care institutions.

Members of this group underwrite the vast majority of bond issues offered for this purpose in America today.

My testimony today expresses our opinions regarding the procedural and cost implications which the administration's legislative proposal would have on the continued use of tax-exempt, bonded debt by nonprofit, community hospitals.

It is noteworthy that during the period 1978 to the present, this type of financing provided slightly in excess of 50 percent of all capital funds and 74 percent of all debt capital available to this sector of the health care industry.

As I will detail in the testimony which follows, Mr. Chairman, it is our opinion that the additional restrictions proposed by the administration as applied to nonprofit, community hospitals are both unnecessary in reaffirming the legitimate public purpose which these financings serve and costly in that compliance would require additional interest expense to be borne by the health care system as well as potentially increasing construction costs.

It has been argued that additional requirements are needed in order to assure that so-called private purpose tax-exempt bonds are issued only to serve a bona fide public purpose. Yet, in the sector of nonprofit, community hospitals categorically, the public purpose test is already satisfied in several different ways.

First, each of these health care institutions is exempt from Federal income taxation under section 501(c)(3) of the Internal Revenue Code. Such a priori tax-exempt status offers strong evidence that the hospital as an institution fulfills a needed public purpose.

Second, the statutory nationwide health resources planning system scrutinizes the public need for all hospital capital expenditures dedicated to construction, whether sponsored by non- or for-profit entities. Each particular project must undergo a rigorous process of detailed application, public hearing, review and approval or denial at both the local and State level. By law, a certificate of need cannot be granted unless the project satisfies public need. As an investment banker, I assure you that it is a practical impossibility to secure capital financing on any basis for a hospital project which has not secured a certificate of need as a condition precedent.

Third, the enabling legislation which creates the bond-issuing authorities, especially statewide bonding authorities, prohibits the issuance of tax-exempt bonds without a prior finding that their use will serve a public purpose. This point, I believe, has been developed by the representatives of the Council of State Health Financing Authorities.

Some have argued that further restrictions on issuing tax-exempt bonds will curb unneeded hospital construction. Experience in the field demonstrates that the facilities planning/certificate of need process is both quite distinct from, and antecedent to, the financing process. Further, our research indicates that the volume of hospital construction versus that of hospital tax-exempt financing have been moving in opposite directions for the last decade. In constant dollars, during the period 1971–79, hospital construction fell 35 percent, from $2.9 to $1.9 billion while, during the same period, issuance of hospital tax-exempt bonds grew over 600 percent from $0.2 to $1.4 billion. If the utilization of tax-exempt bond financing somehow "fueled" hospital construction, we would expect to see a positive correlation here. Yet, we see the opposite. There has been no causal link between the increased use of tax-exempt bond financing and the volume of hospital construction.

Imposing these additional restrictions will also increase costs. Each requirement contained in the administration's proposal would add another step to the process of getting to market. In inflationary periods, the extra time needed to satisfy each requirement translates into increased construction and equipment costs.

In my remaining time, I will concentrate on three of those additional requirements: The local approval requirements, the local contribution requirement, and the increased arbitrage restrictions.

As for local approval, my prior comments have suggested the redundancy of further approval by elected officials. By the time a health care project has been reviewed and approved at both the local and State level of the health resources planning process, and has been subject to public hearings as part of that process, we believe the need for local approval has been met.

The local contribution requirement cannot be fairly applied to nonprofit, community hospitals. As originally proposed by the Department of Treasury, one of the principal ways for meeting this contribution requirement would be an express decision to forgive State and local taxes which otherwise would apply to the facility being constructed with the proceeds of tax-exempt bonds. For nonprofit hospitals, this option cannot be applied as they have a preexisting abatement of State and local taxes which results from their 501(c)(3) status. While there is some reason to believe that the administration recognizes that a general, preexisting abatement of State and local taxes should be sufficient to satisfy this local contribution requirement, I urge this committee, at a minimum, to allow this understanding of the local contribution requirement, as applied to nonprofit hospitals, to become part of any legislation which is passed.

Finally, let me turn to the proposed additional arbitrage restrictions whose costs, while less obvious, are compelling. Please keep in mind that under present arbitrage regulations, all proceeds available from the arbitrage spread must be directed into the construction fund account, thereby reducing the principal amount needed to be borrowed. Using historical spread relationships between taxable and tax-exempt securities, we calculate that these additional arbitrage restrictions would result in bond issues being "up-sized" by approximately 3 percent of the principal amount, that is, a $97 million bond issue would become a $100 million bond issue in order to produce the same net proceeds available for construction. While this increased principal amount may seem modest, its true cost is the consequent increase in debt service payments over the life of the loan. At today's historically high interest rates, amortizing the additional principal required would increase total principal and interest payments over a 30-year term by an amount which equals approximately 15 percent of the original par value of the issue. In the case of our hypothetical $100 million hospital bond issue, these additional arbitrage restrictions would add approximately $15 million in total debt service over the term of the loan. As the vast bulk of that increase would be in the form of interest payments, the Federal Government would absorb a major share of this increased cost as interest expense is a reimbursable item under medicare and medicaid, as previously pointed out by the monsignor.

To summarize, Mr. Chairman, this proposal to place additional requirements on the use of tax-exempt financing for private activities, however laudable its intent, is duplicative in its application, and costly in the effect when applied to nonprofit community hospitals. It fails to satisfy the fundamental cost-benefit test to which any legislative proposal should be subjected. At the margin, it may mean that certain health care institutions, whose need for construction funding has been affirmed by the community at both the local and State level, would be denied access to the private capital market.

So concludes my testimony, Mr. Chairman, but I would be glad to respond to any questions which you may direct.

Mr. RANGEL. Thank you, Mr. Taddey.

National Health-Care Financing Association, Allan Jones.

STATEMENT OF ALLAN O. JONES, VICE CHAIRMAN OF THE BOARD, NATIONAL HEALTH-CARE FINANCING ASSOCIATION, INC., ACCOMPANIED BY PETER M. WRIGHT, TREASURER AND DIRECTOR

Mr. JONES. Mr. Chairman, members of the committee, my name is Allan Jones. I am senior vice president of the investment banking firm of Hereth, Orr & Jones.

However, today I am here in my role as officer and director of the National Health-Care Financing Association. Also with me is Peter M. Wright, who is a partner in the nationally recognized bond counsel firm of Jones, Bird & Howell of Atlanta, Ga., and is also a director of the association.

Others have addressed themselves chiefly to the hospital industry. I will address my comments primarily to nursing homes and related facilities such as mental retardation facilities and life-care centers.

However, my comments apply equally to the small hospitals that are frequently financed with exempt small issues.

The challenge faced by the nursing home industry is staggering. The figures we have obtained from the National Center for Health Statistics indicate that the industry must add approximately 26,000 new nursing home beds a year through the year 2000, to keep up with the needs of our rapidly aging population.

For the 30 years thereafter, the industry must be able to add approximately 37,000 new nursing home beds a year. These figures do not include the substantial number of additional nursing home beds that must be constructed to replace old or obsolescent facilities.

The industry is already falling far short of these goals. The loss of access to the public tax-exempt bond market will result in a dramatic decrease in the already inadequate rate of construction of nursing homes.

And yet the needs of the elderly will simply not go away.

Before I address myself to the administration's specific proposals, I would like to describe a typical IDB-financed nursing home.

The typical facility is 120 beds in size, and could be located anywhere—in the heart of Appalachia, in the Mahoning Valley of Ohio, in a small town in Missouri—anywhere there is determined to be a need for the facility.

The owners of the facility are frequently local figures, although small- and medium-sized nursing home chains are increasingly active.

The owners will have spent at least a year or more getting every aspect of the proposed project approved by several levels of government agencies acting pursuant to the State's certificate-of-need program and/or section 1122 of the Social Security Act.

Specifically, under existing Federal and State laws, the owners will not be allowed to construct a new nursing home unless those governmental agencies have determined that a need for the facility, in fact, exists, and have further approved the project's cost, method of financing, design, location, staffing patterns, and numerous other matters.

When the project is completed, typically it takes about 6 months to fill up, but thereafter occupancy, typically, remains as 95 percent or better and the project soon develops a waiting list.

We find the prospect that the nursing home industry will lose its access to the tax-exempt bond market enormously frustrating. Health care facilities financed through exempt small issues are completely different from other uses of the exemption in that health care facilities serve a genuine social and governmental purpose—namely caring for the sick, elderly, or infirm—as well as providing new jobs, full-time equivalent jobs for each 120 beds.

Consequently, we feel it is incorrect to classify health care bonds as private-purpose bonds.

I would like to turn now to the administration's specific proposals on exempt small issues and other private-purpose bonds. Of course, we certainly don't concede that a health care IDB is a private-purpose bond.

First, it is proposed that all private-purpose bonds must be approved by elected officials or a voter referendum.

We note that a substantial number of States already provide for elected official approvals; others utilize authorities whose members are appointed by elected officials.

The experience under these two systems has not differed materially, either in volume or nature of the facilities financed.

We feel that the decision of which system should be used should be left up to the States.

Of course, voter referendum is not essential as it is a needless expense to the taxpayer.

Second, it is proposed that the local government should make a financial contribution or commitment to any facility which is to be financed with tax-exempt bonds.

This, we feel, is the single most unworkable aspect of the administration's proposals.

At a minimum, this requirement will result in only very few IDB's being issued in most States until the legislatures have had the opportunity to amend their statutes to authorize the granting of the financial contribution.

In addition, in many States, the State constitutions will have to be amended by the electorate to permit local governments to make the financial contribution.

Third, the administration proposes that an IDB-financed facility may not utilize the newly enacted accelerated cost recovery system, but instead, must use straight-line depreciation over an extended recovery period.

Denial of ACRS will deprive health care facilities of an important financing tool: the ability to raise equity capital through a real estate syndication.

Fourth, the administration proposes that a business utilizing IDB's may not have more than $10 million in bonds outstanding after issuance of the bonds.

Most freestanding nursing homes will have no trouble with this provision; however, this provision will frustrate the growth of chains of nursing homes and other health care facilities which can operate with greater efficiency and economies of scale.

This proposal runs directly contrary to the administration's policy of promoting competition in the health care industry.

Furthermore, I fail to see any connection between the size of a nursing home chain and the benefits to the public from allowing a particular project to be financed.

In conclusion, our position is that health care facilities should not be lumped in with golf courses, shopping centers and other private-purpose bond issues, instead they should be given special status.

This may be accomplished either by according this special status within the scope of the small issue exemption, or more logically, putting health care where it belongs—as a new type of exempt facility.

We are happy to say that both the recommendations of the Oversight Committee of this House Ways and Means Committee and the Rangel bill accord special treatment to the health care industry.

Unfortunately, the administration's proposals treat health care facilities the same as fast-food franchises and give no recognition to needs of older Americans' purpose served by the former.

We urge you to stand firm in your support for the elderly citizens of the country and preserve the health care industry's access to tax-exempt financing.

Thank you, Mr. Chairman and members of the committee.

[The prepared statement follows:]

STATEMENT OF ALLAN O. JONES, VICE CHAIRMAN OF THE BOARD, NATIONAL HEALTH CARE FINANCING ASSOCIATION

Honored members, ladies and gentlemen:

My name is Allan Jones. I am an officer and director of the National Health Care Financing Association. The National Health Care Financing Association is a non-profit trade association composed of a broad spectrum of firms and individuals engaged in various aspects of the ownership, operation, management, construction, and/or financing of health care facilities, a term which includes nursing homes, hospitals, mental retardation facilities, and life care facilities. The other panelists here today have addressed themselves chiefly to the hospital industry. To prevent redundancy, I will address my comments primarily to nursing homes and related facilities, such as mental retardation facilities and life care centers. It must be remembered, however, that much of which I will say applies equally to the small hospitals that are frequently financed with exempt small issues.

The challenge being faced by the nursing home industry is staggering. The figures we have obtained from the National Center for Health Statistics and the Bureau of the Census indicate that the industry must add approximately 26,000 new nursing home beds a year through the year 2000, to keep up with the needs of our rapidly aging population. For the thirty years thereafter, the industry must be able to add approximately 37,000 new nursing home beds a year.[1] These figures do not include the substantial nunber of additional nursing home beds that must be constructed to replace old or obsolescent facilities. The industry is already falling far short of these goals. The loss of access to the public tax-exempt bond market will result in a dramatic decrease in the already inadequate rate of construction of nursing homes. And yet the needs of the elderly will simply not go away.

Before I address myself to the Administration's specific proposals, I would like to describe a typical IDB financed nursing home. The typical facility is one hundred and twenty beds in size, and could be located anywhere - in the heart of Appalachia, in the Mahoning Valley of Ohio, in a small town in Missouri - anywhere there is determined to be a need for the facility. The owners of the facility are frequently local figures, although small and medium sized nursing home chains are increasingly active. At any rate, the owners will have spent at least a year or more getting every aspect of the proposed project approved by several levels of government agencies acting pursuant to the State's certificate of need program and/or Section 1122 of the Social Security Act. Specifically, under existing federal and state laws the owners will not be allowed to construct a new nursing home unless those governmental agencies have determined, after public hearings, that a need for the facility in fact exists, and have further approved the project's cost, method of financing, design, location, staffing patterns, and numerous other matters.[2] When the project is opened, it typically takes about six months to fill up, but thereafter occupancy typically remains at 95% or better and the project soon develops a waiting list. Typically, seventy to eighty percent of the patients will be supported through the Medicaid program, of which a typcial state may pay 40% of the cost and the federal governmental 60%. These cost reimbursements pay not only for operating costs, but also for interest on the bond debt and depreciation of the project.

---

[1] According to the Bureau of the Census and the National Center for Health Statistics, the number of individuals aged 65 or over was 25.5 million in 1980, and is estimated to be 31.8 million in 2000 and 55.0 million in 2030. The number of licensed nursing home beds in 1978 was 1,303,100, and the estimated need in 2000 is 1,900,000 and in 2030 is 3,000,000.

We find the prospect that the nursing home industry will lose its access to the tax-exempt bond market enormously frustrating. We feel that health care facilities financed through exempt small issues are completely different from other uses of the exemption in that health care facilities serve a genuine social and governmental purpose - namely caring for the sick, elderly or infirm, - as well as providing new jobs. Consequently, we feel it is incorrect to classify health care bonds as "private purpose bonds".

---

[2] Certificate of need laws are state laws originally adopted as a condition to obtaining federal participation in various grant programs, but which have since taken on a separate life of their own as states have discovered just how expensive their share of the Medicaid program is and now expensive it is to permit uncontrolled growth in the number of nursing home beds. Consequently it is unlikely that the states would drop their certificate of need programs even if Congress eliminated the federal requirement that they be maintained.

We note that much of the impetus for the Administration's proposals to restrict what it regards as "private purpose bonds" comes from the assumption that the issuance of such bonds produces a revenue loss to the federal treasury. The assumptions and conclusions of the Congressional Budget Office study have been convincingly rebutted by industrial users and issuers who have appeared before this Committee, and it is not necessary to restate their arguments here. We do, however, wish to point out that in addition to all the arguments that industrial users and issuers have brought to bear to refute the assumption that IDB's cause a revenue loss, there is one further factor that is completely unique to the health care industry. Under the Medicaid program, a pro-rata portion of the interest cost on a health care facility's indebtedness is reimbursed directly by the federal and state governments. Thus on a typical new construction nursing home which is 70% occupied by Medicaid patients, 70% of the interest cost on the permanent financing is paid for by the federal and state governments in an approximately 60%-40% ratio. On such a nursing home, therefore, approximately 42% of the interest cost will be paid by the federal treasury. If nursing homes are forced to borrow at higher conventional rates, then, in the unusual cases where conventional lenders can be found who are willing to lend at such rates, 42% of the increased interest cost will be paid for by the federal treasury. This factor greatly reinforces the already convincing arguments made by industrial users and issuers to the effect that an average IDB produces a revenue gain, not a loss. We also note in this regard that the amount of health care financing taking place under the small issue exemption is extremely limited in amount. Most hospitals cost over $10,000,000 and cannot be financed under the exemption; and nursing homes are quite inexpensive - about $2,500,000 in bonds for an average 120 bed nursing home. Consequently, even if one were to adopt the rationale and conclusions of the CBO study, one would be forced to conclude that any revenue gain resulting from elimination of health care IDB's would be negligible.

I'd like to turn now to the Administration's specific proposals on exempt small issues and other so-called "private purpose" bonds.

First, it is proposed that all "private purpose" bonds must be approved by elected officials or a voter referendum. We note that a substantial number of states already provide for elected official approvals; others utilize authorities whose members are appointed by elected officials. The experience under these two systems has not differed materially, either in volume or nature of the facilities financed. We feel that the decision of which system should be used should be left up to decision as to which system should be used be left up to the states. Of course, voter referendum is entirely impractical: the cost and time delays are prohibitive.

Second, it is proposed that the local government should make a financial contribution or commitment to any facility which is to be financed with tax exempt bonds. This, we feel, is the single most unworkable aspect of the Administration's proposals. Nearly all state constitutions contain provisions prohibiting the lending of credit by a state or political subdivision to private parties, or the incurrence of debt by the state or a political subdivision without and election. These requirements are strictly construed, and the foundation of the entire IDB financing method are a series of test cases decided by the supreme courts of each state determining that under carefully drawn state laws or special constitutional provisions, no lending of credit or incurrence of debt was involved. The basis of these decisions generally lies in (a) the absence of a financial commitment by or debt of the state or any political subdivision, and (b) in many jurisdictions, the fact that the bonds are not authorized or issued by a state or political subdivision, but instead by a separate authority which is deemed not to be subject to the constitutional limitations. Where courts have relied on the latter theory, problems may be created if the federal government imposes the proposed requirement described above that the bonds be approved by elected officials. Furthermore, virtually all jurisdictions the proposed financial contribution requirement will conflict sharply with these constitutional limitations, with the result that in most states bond issuers will not be able to obtain an approving opinion of bond counsel until the statutes and constitutional limitations have been amended by the legislatures and the electorates, respectively, and new test cases brought and decided. We have checked with bond counsel in most states, including all of the states which are represented on the House Ways and Means Committee, and have been generally advised that the financial contribution requirement will bring most IDB financing to a standstill. Copies of a number of opinions of bond counsel to this effect are being submitted herewith to the Committee. We would also like to observe that adding a financial contribution requirement seems particularly unncessary in the health care industry where the states are already paying a substantial portion of the debt service on health care IDB's through the Medicaid program.

Third, the Administration proposes that an IDB facility may not utilize the newly enacted accelerated cost recovery system, but instead must use straight line depreciation over an extended recovery period. Denial of ACRS will deprive health care facilities of an important financing tool: the ability to raise equity capital through a real estate syndication.

Fourth, the Administration proposes that exempt small issues be limited to small businesses, and that a business utilizing IDB's may not have more than $10 million in bonds outstanding after issuance of the bonds. Most free standing nursing homes will have no trouble with this provision; however, this provision will frustrate the growth of chains of nursing homes and other health care facilities which can operate with greater efficiency and economies of scale. This proposal runs directly contrary to the Administration's policy of promoting competition in the health care industry. Furthermore, we fail to see any connection between the size of a nursing home chain and the benefits to the public from allowing a particular project to be financed.

Our position is that health care facilities should not be lumped in with golf courses, shopping centers and other "private purpose" bond issues; instead they should be given special status. This may be accomplished either by according this special status within the scope of the small issue exemption, or more logically, putting health care where it belongs - as a new type of exempt facility.

We are happy to say that both the recommendations of the Oversight Committee of this House Ways and Means Committee and the Rangel bill accord special treatment to the health care industry. Unfortunately, the Administration's proposals treat health care facilities the same as fast food franchises and give no recognition to the vastly greater public purpose served by the former. We urge you to stand firm in your support for the elderly citizens of the country and preserve the health care industry's access to tax-exempt financing.

Mr. RANGEL. Mr. Peter Wright.

Mr. WRIGHT. I have no further comments. I am here to answer questions, should they be asked.

Mr. RANGEL. Thank you.

Are there members of the committee that have questions of this panel?

Mr. ANTHONY. Yes, sir, Mr. Chairman.

Mr. RANGEL. The American Association of Retired Persons testified before this committee that they were supporting the administration's effort to restrict the use of tax-exempt bonds because they believed that this tax-exempt financing contributed substantially toward the medicare costs.

Have you heard of that testimony?

Reverend CASSIDY. I heard about that stand and I am totally baffled on why they are doing that. The people need health care most, are really the elderly. I think they don't realize that most of these bond issues we find with our hospitals, 80 percent is renovation of hospitals so they can stay in existence.

Our problem is you won't meet the code if you don't renovate and the regulators will put you out of business.

So if you don't have that tax-free bond, we will not be able to continue to be able to serve the elderly at all.

I don't think they are aware of this.

Mr. RANGEL. Are there other members of the committee that wish to have an opportunity?

Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. Taddey, I just have some broad questions. On page 2 of your testimony, you talk about the fact that there is a review process and a certificate of need has to be granted.

Is that not proposed to be eliminated?

Mr. TADDEY. Well, some of the regulations under Public Law 93-641 are presently proposed to either be severely scaled down or eliminated.

A part of those proposals do deal with the health planning process and the funding of certain Federal programs in order to keep the health systems agencies or HSA's, which are the regional planning and certificate-of-need advisory groups, in business, that's correct.

Mr. ANTHONY. If there was that elimination, would that change that part of your testimony any? Do you think there would still be sufficient control?

Mr. TADDEY. Congressman, I believe that the essence of prudent capital financing is capital planning.

I don't think any major corporation or nonprofit would embark on a major capital financing program without planning.

Now, if, in fact, part of the regulatory framework upon which major capital financing plans has been predicated is eliminated, then I believe that an alternate model would have to be in effect.

Would that change my testimony? No; it would not, Mr. Congressman, only because I believe that besides the certificate of need presently—that legislation, there are a lot of other criteria by which the rating agencies and bond market evaluate feasibility of projects, this being one, although the most important one, I believe.

Mr. **Anthony**. Let me get a question on the table and then anybody else that wants to respond to any of these questions, feel free to interject.

I want to know what your prognosis for interest rates is for 1982 and 1983, short term and long term.

Mr. **Taddey**. I think that the consensus view, most of those on Wall Street, to the extent there is any consensus, is generally that rates will be trending upward throughout the summer, that hopefully as certain elements of the present recession we are in take hold, that there may be some leveling rates, both in the long- and short-term markets, toward the end of the summer, end of the third quarter, and hopefully we will have a more stable pattern of interest rates and maybe even some minor declines in the long-term markets, commencing around the fourth quarter of this year.

I think that that would hold true, both for long-term taxable rates, as well as long-term, tax-exempt rates.

Mr. **Anthony**. If they trend down in the fourth quarter, what would you project or what seems to be the consensus for the outyears, 1983, for example?

Mr. **Taddey**. I am sorry?

Mr. **Anthony**. The prognosis for interest rates in 1983? Say they start trending down in the fourth quarter.

Mr. **Taddey**. As you get further out, the consensus becomes less and less as a general matter. There, I don't believe there is any real body of opinion that I could point to as being dominant.

However, as far as the forecast that I assign the most credibility to, I think what they are projecting is that rates may, in fact, begin to trend upward again around the end of the first quarter of 1983 simply because lowering rates will produce more borrowers, borrowers on short-term debt will want to go to bonded debt and, therefore, the demand for long-term capital funds may increase and this may cause a temporary increase in interest rates.

Again, though, as you go through the balance of the third and fourth quarter of next year, and as the excess demand subsides, we are hopeful that rates over time will again continue to level and trend downward.

Mr. **Anthony**. Mr. Chairman, with your permission, I have one final question I would like to at least get on the record.

Mr. **Rangel**. Yes.

Mr. **Anthony**. What Government action would help bring these interest rates down? In other words, you have given us a fairly pessimistic prognosis for the rest of this year and for the trend into 1983.

I guess if I was a member of any of your associations thinking about trying to finance a construction project with long-term exempt or nonexempt securities, I would be back doing a lot of planning because it really looks scary from what you say.

What Government action, in your opinion, could we take or what government action would help bring interest rates down?

If you don't want to answer today, you can submit a letter on it.

Mr. **Taddey**. I would be happy to express my own opinion on that, Congressman.

I believe that the key factor that is eroding the confidence of Wall Street and of the investing financial community, as far as being able to accept securities, including tax-exempt bonds in more favorable interest rates, has to do with the apparent conflict we perceive between an overly restrictive monetary policy and overstimulative fiscal policy.

I believe that while the Federal Reserve System is charged primarily with the brunt of battling inflation, in fact, holding down the monetary aggregates, while on the other hand, the fiscal side of the balance sheet is continuing to expand with all of the admitted difficulties in holding the budget down, this is eroding the confidence of the major institutional and retail investors in the market.

Now my recommendation, sir, would be to maintain a steady course as far as monetary policy and to do all we can to eliminate the rolling deficits on the fiscal side of the balance sheet.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. RANGEL. Are there any other questions?

If not, I don't know the scenario by which the committee and the administration who sent up the tax bill mean to proceed. I guess it is clear to everybody that Congress is looking to cut back the deficit and obviously those that are opposing the use of IDB's are claiming that it is a tremendous cost to the Federal Government to continue to support the policies we have supported in the past.

I just hope as we try to reach some accord in this area that we don't find your segment of the population asking us to support an overall program without assisting us in hammering out a package where we could protect the hospital industry and at the same time expect that we can get some support for a meaningful tax bill that perhaps would allow more revenues to flow toward balancing the budget.

The embarrassing thing for members of this committee—and I assume that same occurs on the other side of the House—is that everyone wants to balance the budget. Everybody wants to cut back the deficit. Everybody wants to get a handle on interest rates.

Everybody wants to support the President, too. It is difficult to pick out that part of the President's program that you don't like and make it abundantly clear that it won't work for you.

Then we are asked to cast one vote and find out that your support is on the other side of that question. I know it sounds very political and I mean it to sound exactly that way.

If we are going to figure out a package, we have to figure out revenues somewhere, we have to cut spending somewhere.

I hope it is not in the area where you have a concern, but many of the cuts we are feeling this year are as a result of other people saying you have to give the President's program an opportunity.

Most of you mentioned certificates of need. I don't know how many of you will be supporting the legislation requiring certificates of need.

It is good to see that since it is here we can rest assured that it is a safeguard against unnecessary beds. But there is no question that you support the President or anybody else, that we are talking about lack of regulations and more freedom to do the things that you know how to do best without a lot of redtape.

So it is a problem and I know I didn't add to the solution, but when the votes are counted, I hope I have a clear picture of where we are going, rather than just a package from which I find that I can't pull out only those parts that I support.

Thank you.

Mr. WRIGHT. I would like to speak just for a minute to the certificate-of-need question which was raised twice. The certificate-of-need laws may have had their stimulus through Federal statutes, but they are matters of State law, and the certificate-of-need programs are administered by State agencies under State laws.

The State's experience under the medicaid program has been one of extreme rapid rise in cost and pressure on their budgets and they are very anxious not to have unneeded beds built.

Consequently, I think whatever the Federal Government does, you will find strong opposition in State legislatures to dismantling their own State programs that require extensive approvals before any nursing homes or hospitals could be built.

Mr. RANGEL. I would hope that you are right, Mr. Wright, but I don't think any of you support all of this State and Federal regulation.

Mr. WRIGHT. Speaking individually, I think the certificate-of-need program is very desirable and beneficial.

Mr. PHILLIPS. Mr. Chairman, most of the State authorities that issue these tax-exempt bonds are tied in by statute to the certificate-of-need process within their individual States.

To give you some idea as to what the impact has been, everyone we have heard has been talking about the impact of tax-exempt bonds on bed capacity.

In 1981, a survey of 11 State authorities had bond principal amounts sold of $914,974,000. That resulted in a bed increase among those 11 authorities of 172 beds.

That is not where that money is going. It is really going into renovation, creation of ambulatory care services, and this, in theory, is being done to reduce the cost of health care to America.

Mr. RANGEL. Well, I hope you allow your voices to be heard beyond these chambers. Thank you very much.

The next panel is the Association of American Universities, we have the Honorable Terry Sanford, president of Duke University, and former Governor of North Carolina, representing the American Council on Education, as well as the National Association of Independent Colleges and Universities; Loyola University, also, Paul McFarland, vice president for finance; from the University of Minnesota, Frederick Bohen, vice president for finance and operations; the Higher Education Assistance Foundation, Richard Hawk, chairman of the board; and from Boston College, John Smith, vice president for financial affairs and treasurer. He will have with him Francis Mills, M-i-l-l-s, director of finance planning.

The chairman of the full committee thanks you all for coming. As you know, your full testimony will appear in the record.

You can highlight as you see fit. I want to thank you, Governor, for being with us. I recently had an opportunity to speak at Duke University and I am amazed at its beauty and historic value and I know you must be a proud president to administer such a great university system.

I was impressed, not only with the grounds, but the student body and the relationship that I enjoyed.

Thank you very much for coming. You may proceed, Governor.

STATEMENT OF HON. TERRY SANFORD, PRESIDENT, DUKE UNIVERSITY (FORMER GOVERNOR OF NORTH CAROLINA), ON BEHALF OF THE ASSOCIATION OF AMERICAN UNIVERSITIES; AMERICAN COUNCIL ON EDUCATION; AND NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES

Mr. **Sanford**. Thank you very much.

I am delighted to have a chance to be here. I always feel somewhat embarrassed to come before a congressional committee and say do something special for us, or give us some special position because I realize you have the problem of putting together a package that needs to take into consideration all of the concerns.

I would like to make the point today that this proposed legislation not only puts a severe but I think an impractical limitation on postsecondary education. My concern is that we are lumped in with the wrong group. The activities of 501(c)(3) universities and teaching hospitals are not at all similar to the activities of companies or industries that are generally using industrial development bonds.

I suggest that for various reasons it would be best if we were not included. First of all, we are such a small part of the total number of bonds issued. Second, we could hardly call activity in teaching hospitals or in universities and colleges, a private activity. That suggestion overlooks the public and charitable purposes of these institutions.

Bonds for universities are used for two purposes. The first purpose is for buildings and equipment. It is not possible to pay for things to be done, including renovations, unless we have borrowing capacity to be repaid on a reasonable basis.

The second purpose is for student loans. Right now with guaranteed student loans in doubt, we need even more in this capacity. I would say that there are about three ways across the country that tax-free bonds are used to support the guaranteed student loan program.

First of all, in a great many areas where the private lender is not readily available, it is necessary to have this kind of pool of money simply to make available money for those people who are qualified for guaranteed student loans.

Second, it is necessary to have it for the secondary market to take out the private lender in order that the private lender may roll over and apply funds to additional student needs.

Third, in order to meet the middle-income need that does not quite fit the federally defined category for guaranteed student loans, we need a pool of money. We are very careful at Duke, and at most institutions I know anything about, not to make those loans except on the basis of need. There is often, however, need in the middle income family group that does not meet the requirements of other loan programs.

I think the student loan program is almost too small to measure in relationship to the total bonds issued under these general categories. But all of this is just a splendid investment in the future as it opens up access to higher education for young people.

So, it is not in question that this is not a private activity but a broad public interest activity in the best sense of that term.

At Duke, we have used bonds for our recent hospital expansion. I do not think we could have done it and certainly we could not have done it and maintained rates as we have without it. Currently, in North Carolina we are voting a constitutional amendment up or down next month to declare private institutions eligible for tax-free bonds just as public institutions have been over the years.

It requires a constitutional amendment but it comes out of a pressing need of the schools. We simply do not have enough housing. We have been crowded in and we would like very much to get ahead of the game while costs are what they are and several other buildings are needed, and the only way we can do it is to rely on tax-free bonds.

Just hurriedly, we have three or four reasons, and three or four comments about the necessity for being exempt from or not included in the new legislation. We do not have what the Treasury Department suggested was a proper alternative to tax-free bonds, that is, we do not have the availability of depreciation or do not have a chance to use accelerated cost recovery. It just does not fit our kind of an institution.

So, there is not any way that we can go except this way if we want a feasible financial package.

I would also just note that the hearing by a public official is not exactly feasible in higher education and private institutions within higher education in particular. There are many other safeguards and of course our bonds and our particular boards of trustees are even more cautious than public officials would be.

This looks to me like an unnecessary intrusion of public authority in the affairs of the private institution for no particular good purpose.

I think that the 1-percent contribution requirement certainly would be doubtful in the case of bonds for higher education. As I read it, it is possible that tax abatement applies and there would not have to be an actual 1-percent contribution to something we were doing at Duke, for example.

But 31 States by their constitutions prohibit any contribution to private colleges. These prohibitions would create great problems. In addition there is no tax abatement for student loans so that would not fit the category. The 1 percent would be an awkwardness which probably could not be overcome in over half of the States.

It seems to me the contribution would serve no useful purpose.

In summary and in appreciation for your giving me a chance to say something, I simply would summarize by saying that I hope you will treat the functions of 501(c)(3) institutions not as private activities but as public purposes, which indeed they are.

Thank you very much.

Mr. **Rangel**. Thank you, Governor.

[The prepared statement follows:]

STATEMENT OF PRESIDENT TERRY SANFORD, DUKE UNIVERSITY, ON BEHALF OF NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES; AMERICAN COUNCIL ON EDUCATION; AMERICAN ASSOCIATION OF STATE COLLEGES AND UNIVERSITIES; ASSOCIATION OF AMERICAN UNIVERSITIES; ASSOCIATION OF CATHOLIC COLLEGES AND UNIVERSITIES; ASSOCIATION OF JESUIT COLLEGES AND UNIVERSITIES; NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS; AND NATIONAL ASSOCIATION OF STATE UNIVERSITIES AND LAND-GRANT COLLEGES

I am Terry Sanford, President of Duke University and immediate past Chairman of the Association of American Universities. I testify this morning on behalf of the AAU, the American Council on Education, the National Association of Independent Colleges and Universities, the National Association of State Universities and Land Grant Colleges, and several other national higher education groups, as noted on the cover sheet. I appreciate the opportunity to appear today to address a matter of critical concern to Duke University -- a concern shared by very many colleges and universities and their students all across America.

I appear this morning in opposition to the Treasury Department's proposal to impose severe restrictions on the ability of institutions of higher education to finance vital facilities construction and student loans using tax-exempt bonds.

Tax-exempt bonds are today utilized for two major purposes in higher education:

1. To obtain capital needed for constructing and renovate educational facilities such as teaching hospitals, dormitories, and student unions, as well as major equipment purchaces needed for modernization and research; and

2. To raise capital for student loan programs, to assure that all eligible students will have access to higher education. Student loan bonds are utilized in three ways:

(a) to guarantee loan certainty to students eligible for the federal Guaranteed Student Loan (GSL) program but unable to find a commercial lender willing to make a loan;

(b) to provide a secondary market for GSL's, which creates the investment liquidity necessary to encourage the continued participation of lenders in the states; and

(c) to supplement directly the GSL program by providing loans to students and their parents who do not meet the new GSL restrictions and cannot obtain loans from other sources. This latter use provides some relief to students from middle income families who cannot meet the more severe means test created for federal loans but cannot finance their educations without borrowing.

The Treasury Department's proposals would sharply limit and perhaps eliminate this important capital funding vehicle. Both the purpose and the plan of those proposals are badly conceived. In its "general and technical explanation," the Treasury Department urges adoption of its proposals in order to raise federal revenues and to decrease the influence of "private purpose" tax exempt bonds on the capital markets. But applying the proposed restrictions to charitable organizations advances neither goal. The volume of 501(c)(3) bonds is negligible in the tax-exempt market. For this reason the revenues to be gained are inconsequential and the effect of removing them from the crowded capital markets will pass almost unnoticed.

The real effect of the Treasury proposals is, unfortunately, quite clear. The measures would seriously damage the capacity of our country's institutions of post-secondary education to efficiently deliver first-rate instruction to the entire spectrum of deserving students and research of the highest quality .

Mr. Chairman, permit me to observe first that any attempt to sweep charitable institutions within the ambit of restrictions on "Private Activities" is inappropriate on its face. On this fundamental and important point of principle the Treasury has gotten itself mixed up. Tax-exempt bonds provide funds to our non-profit colleges and universities for the execution of clear and essential public purposes. Denial of this traditional and efficient form of financing would produce significant public loss. Colleges and universities use tax-exempt bonds for the traditional kinds of public purpose activities which the Internal Revenue Code requires as a precondition to exempt status under Section 501(c)(3). It distorts reality to suggest in any way that the tax-exempt financing of 501(c)(3) organizations serves anything but public purposes. I cannot stress too strongly that the rationale for the tax exempt status of our institutions is that they serve purposes and carry burdens that the government and its treasury would otherwise bear. When this truth is recognized, our purposes cannot be termed private.

Careful analysis of the Treasury Department's proposal confirms the inappropriateness of restrictions on 501(c)(3) bonds. Treasury points to abuses, and stresses the tax shelter benefits that can be realized in combining tax-exempt financing with the Accelerated Cost Recovery System (ACRS) and the investment tax credit. But the investment tax credit and rapid depreciation write-offs of ACRS are tax subsidies not even available to charitable organizations.

Treasury's proposed solution for business corporations is to offer a choice between ACRS and tax-exempt financing; no such alternative exists for non-profit organizations. Only one favorable financing window -- the use of tax-exempt bonds -- is open to us now. If the Treasury Department succeeds, through the proposals before you, in closing that windown, our educational institutions must resort to conventional financing -- available, if at all, at prohibitively high interest rates.

Ironically then, the burdens Treasury is seeking to impose will fall not only inappropriately on educational institutions, but will fall on them more harshly than on the genuinely "private purpose" bond issuers who are the purported targets of the restrictions.

Mr. Chairman, according to U.S. Budget documents, student loan bonds are one of the smallest categories of revenue bonds listed in the entire Budget. In FY 1983, total revenue expenditures in this category amount to only $155 million.

The Treasury Department asserts that a 58 percent annual increase in total student loan bond volume over the past several years compels restrictions. Treasury's argument is seriously misleading. The increase cited begins with a base more than 14 times smaller than the next largest category of non-government issued tax-exempt bonds. And even with the increases, student loan bonds are still the smallest measurable category of non-government tax-exempt bonds. The truth is that in FY 1983, student loan bonds will amount to just 2.6 percent of all long term tax-exempt issues and 4.5 percent of all non-government-issued tax-exempt bonds.

Treasury itself estimates it will gain only $9 million in FY 1983 from restrictions on student loan bonds. On the assumption that the number of such financings will not decrease, the Department projects revenue gains for the Treasury of $15.4 million in FY 1984 and $49.3 million in FY 1985. But under the proposed restrictions, even those modest revenue additions will fail to materialize because such financings will drop significantly, and perhaps end entirely.

Against this background, it is worth noting that in advancing its proposal, the Department has ignored the Congress's mandate in the Higher Education Act of 1965 [as amended 1976, 1980], which has created incentives and subsidies -- including tax-exempt financing -- to encourage states to establish loan agencies to guarantee that students, regardless of residence and banking relationships, have access to loans for college studies. This federal government initiative began in 1976, and is only now reaching the goal Congress set.

Let me conclude my remarks on the minimal budgetary justification for restrictions on 501(c)(3) tax-exempt bonds by noting that with regard to bonds for educational facilities and equipment purchases, the revenue gains involved are so small that no government figures on them exist. They are too insignificant in volume for the Treasury to monitor for revenue loss -- a circumstance directly inverse to their enormous importance to the institution seeking affordable ways to build a dormitory, restore its structural facilities, or modernize its equipment.

Mr. Chairman, I hope I have made clear that while higher education tax-exempt bonds are almost invisible compared to other kinds of tax-exempt bonds, they are a crucial part of our shrinking financial base. Concordia College in Minnesota, for example, recently used tax-exempt facilities financing bonds for construction of an academic building, providing laboratories, classrooms, and offices for the biology and home economics departments of the college. Loyola College of Maryland financed the acquisition of an existing apartment complex, furnished and equipped it, and provided housing for approximately 400 students. The University of Chicago recently modernized its telecommunication systems; over time, telephone charges and computer operating costs will probably decline.

In my own state of North Carolina the need for tax-exempt financing among independent colleges and universities is acute. The legislature has approved, and sent to the voters, a state constitutional amendment broadening tax-exempt bond availability for facilities financing. Several institutions hope to use this mechanism soon. St. Andrews Presbyterian College, in Laurinburg, North Carolina, identified a number of critical projects it hopes to finance through tax-exempt bonds, including renovation of the boiler house, new plumbing, expansion of the library, renovation of the science building, new electrical systems, and fire detection. St. Andrews enrolls a large number of handicapped students, and hopes to renovate housing to improve accessibility. The Treasury proposals endanger each of these projects.

Mount Olive College has determined that a new health education facility is absolutely essential to its continued development, and has planned a $2.5 million facility. Mount Olive has already raised $1.4 million and hopes to finance the rest through tax-exempt bonds; Of course, $2.5 million of construction would be very significant to the economy of the Mount Olive community. The Treasury proposals threaten this project as well.

At my own institution we have urgent need for tax-exempt financing. Duke anticipates using tax-exempt bonds for constructing student housing, completing our business school facility, developing an automated energy management and conservation system, and purchasing computers and other equipment we critically need to continue our research efforts. We must also plan for the financing of a great accumulation of deferred maintenance on our plant and equipment, a task involving large sums of capital.

Teaching hospitals are another especially important use of tax-exempt bonds. The Duke Hospital, for instance, which we constructed using tax-exempt bond financing, will provide $82 million in Medicaid, Medicare, and charity care this year - 48 percent of its total budget; of course, the balance of its activity exclusively involves health care, a charitable or public purpose.

Stanford University is now in the process of modernizing its teaching hospital, with no hospital bed increase included. The total cost of the program is $122 million, $80 million of which Stanford hopes to finance with tax-exempt bonds. The University will finance the remainder with private giving reserves, as was the case with the Duke Hospital addition. Without tax-exempt bonds, the cost of the modernization could be 3 to 10 percent higher, threatening the viability of the entire project.

The continued availability of tax-exempt facilities financing is extremely important for our institutions. In many cases, it makes the difference between succeeding or failing in a renovation or construction project. It permits institutions to undertake crucial capital improvements outside the fierce grip of current, punishing interest rates. It also fills some of the gap caused by the termination of or reduction in low-interest government facility loan programs. It may allow construction when a project is needed, rather than when fundraising campaigns are concluded. It frequently makes possible renovations which produce more efficient facilities, reducing long-term energy and other operating costs; and many of these savings are directly reflected in lower costs for federally-supported research. And can permit construction and renovation projects to proceed even in today's depressed building environment, providing desperately-needed stimulation to hard-hit local economies and small businesses.

Student loan bonds are equally as important as facilities financing bonds. Many students seeking assistance under the GSL program are eligible for guaranteed loans but do not have established banking relationships, and therefore have great difficulty obtaining GSL's. Many states don't enjoy the advantage of being money centers with sufficient capital to meet the GSL need by using funds held by commercial lending institutions; these capital-short states cannot meet the full student loan needs of residents without a supplementary source of capital. Such states, like my own state of North Carolina, fill that gap with revenue bonds, thus providing access for all eligible residents in both public and independent higher education. In North Carolina $119 million of such bonds are outstanding. Nationally, 20 percent of all GSL loans rely on tax-exempt bond financing.

Another student loan program, supplementing GSL's, recently began in Illinois, Iowa and Massachusetts, and is under consideration in several other states. This program, which is expected to issue its first bonds this summer, will assist parents and students from moderate and middle income families who cannot meet the recently-enacted, more severe GSL eligibility criteria and who can't obtain loans from other sources. Colleges participating in the program pledge their collateral, their reputations, and their their commitment to due diligence in collections to secure the capital for these new student loan funds.

In each of the facilities financing and student loan areas I've discussed, tax-exempt bonds play a critical role in keeping our higher education system healthy. By no standard of measurement, and in pursuit of no rational national objective, do restrictions on higher education's financings through tax-exempt bonds belong in the Treasury Department's proposals.

Mr. Chairman, let me touch on three of the Administration's proposed restrictions which would sharply curtail such financings for higher education and thereby gravely undermine our entire purpose and effort. These are restrictions which would:

-- require new and additional financial commitments by a state or local government in support of a bond issue;

-- impose further arbitrage restrictions, and

-- create a time-consuming, costly, and possibly insuperable new approval process for each bond issue.

A financial contribution by a local or state government equal to one percent of the face value of the bonds, as the Department proposes, is more than inappropriate. It is an affront to the principle of exempt status for 501(c)(3) organizations. State and local authorities now extend to 501(c)(3) entities tax abatements largely consistent with those provided by federal law -- and they do so for the same reasons of advancing public purposes. Thus, state and local governments are already doing their part, and giving their fair share for these public purposes.

Treasury seems to suggest -- but quite unclearly -- that for educational facilities, the contribution may take the form of some additional local or state tax abatement. If this interpretation is correct, the Department fails to articulate any reason for this additional definition of state or local responsibility. No similar provision is proposed for student loan bonds. One is left to wonder how how such loan bonds could satisfy this requirement except by out-of pocket contributions from state or local government. But most hard-pressed units of state and local government can afford to make no additional financial contributions to higher education. These units of government across America are already fighting budget constraints to keep alive a diminishing array of state educational grants as well as loan programs. New money just isn't there at the state level -- nor can we fairly expect it to be.

Mr. Chairman, beyond these appalling budgetary limitations, as many as 31 state constitutions and statutes prohibit state or local government contributions to independent colleges and universities as contemplated in the Treasury proposal. The one percent contribution requirement in these states threatens complete elimination of the bonds and poses a grave danger to the existence of independent higher education in the United States.

Placing further and more stringent arbitrage requirements on college and university projects during the temporary construction period has serious consequences. For self-financing facilities, such as student dormitories, the institution receives no offsetting revenues in this period. Thus it must issue more bonds to take into account the loss of funds during the construction period, or allocate additional internal resources from strained current operating budgets or badly-buffeted endowments. For projects such as equipment purchases, which are undertaken to reduce operating costs over time, the arbitrage requirements further strain institutional budgets. As to arbitrage restrictions on student loan bonds, the Treasury Department has failed to take into account additional burdens flowing from recent Congressional action. In 1980 Congress reduced by 50% the special allowance paid by the federal government to GSL lenders that raised capital through the tax-exempt bond market. And for all bonds, it is necessary to maintain the exclusion from arbitrage of debt service reserve funds. Such funds and their proceeds provide security on the actual loan funds and are an essential part of program costs.

Mr. Chairman, the third and final inappropriate requirement is for public hearings and approval by elected officials for each bond issue. This provision is again inappropriate, heavy-handed, and gratuitous as it relates to the public purpose character and role of exempt organizations. The requirement will increase capital formation costs, severely hamper lender flexibility in timing bond sales, delay receipt of bond proceeds, and create unwarranted political pressures for smaller, less cost-efficient bond issues. Timely construction of facilities and granting of student loans would be jeopardized. The irony is that this requirement is quite unnecessary: state legislatures and other governing bodies have already developed procedures to properly regulate and coordinate the issue of tax-exempt bonds, assuring that the public interest is met.

Finally, Mr. Chairman, I must conclude my remarks with an expression of great worry. For even as the Administration sounds clarion calls for the private sector -- especially charitable institutions -- to replace the federal government in activities vital to our country's cultural, economic, and technological development, we find our capacity to meet that challenge persistently undercut. Proposals such as these from Treasury, which severely reduce our financial assistance opportunities, threaten our best students -- including essential young research scientists. And, as we are learning through our experience with the effects on charitable giving of the Economic Recovery and Tax Act of 1981, tax changes can cause serious unforeseen harm to important but vulnerable enterprises like ours.

I urge you to maintain the current law's treatment of revenue bonds which tax-exempt organizations issue.

Thank you.

Mr. RANGEL. Mr. Hawk, chairman of the board, Higher Education Assistance Foundation.

STATEMENT OF RICHARD C. HAWK, CHAIRMAN OF THE BOARD, HIGHER EDUCATION ASSISTANCE FOUNDATION

Mr. HAWK. Mr. Chairman, members of the committee, with all due respect to the Department of the Treasury, we believe that the restrictions and limitations which the Treasury has proposed for student loan revenue bonds do not make a great deal of sense.

First of all, they do not make sense because they are irrelevant for determining the public purpose of a bond issue for student loans. That public purpose has been determined by the Congress already. Indeed as you know very well, the Congress has provided for certain Federal subsidies for guaranteed student loans.

Moreover, the Congress has enacted into law some very specific requirements with respect to student loan revenue bonds. That law appears in the Higher Education Act as amended. There clearly is no evidence of need for additional restrictions nor is there any indication that additional restrictions would be desirable.

In addition to being irrelevant from the standpoint of public purpose, it seems to us that the proposal for student loan revenue bonds is unnecessary from the standpoint of Federal funds, because the Congress has provided for a compensating reduction in expenditures for any revenue which may be lost as a result of the tax exemption on student loan revenue bonds.

As you know, the Congress has provided for special allowance payments to lenders and holders of student loans as an interest supplement. As you also know, in the event that the lender has financed the loan with tax-exempt revenue bonds, the amount of the special allowance is reduced by 50 percent or one-half, so it seems to us these proposals are not necessary from the standpoint of any revenue loss to the Federal Government.

Even more important, it seems to us that these proposals are damaging to the national interest in making postsecondary education accessible to the young people of this country. A reduction in student loan revenue bonds would translate directly into a lack of adequate funds to provide access to loans, and lack of opportunity to obtain funds to meet the costs of postsecondary education, translates very directly into a denial of opportunity. There is nothing, I would suggest, more important in a free society than access to education.

Finally, we believe that the Department of Treasury proposals with respect to student loan revenue bonds would be discriminatory against those States which are already having difficulty in providing adequate capital to meet student loan needs. There are some States which are in the fortunate position of having sufficient funds supplied by commercial lending institutions within those States and those States have not found it necessary to utilize tax-exempt revenue bonds as a supplementary source of capital.

However, there are quite a number of other States in which the competing demands for all of the resources or funds held by commercial lenders result in a deficiency with respect to the availability of funds for student loans. To penalize those States which are already having difficulty in meeting the need would seem to us not to make much sense.

If the Congress should determine that there should be a State finanical contribution to the guaranteed student loan program, then it ought to be done in some way which affects all States equally and not in a manner which would descriminate and place a hardship on the States already having difficulty in meeting the total need.

Finally, Mr. Chairman, and members of the committee, I would suggest that the recommendations of the Treasury do not even make a great deal of sense politically. I would cite as an example of that an action which occurred very recently in one of the States in which Foundation serves as guarantor of student loans. That was the State of Kansas.

Last Friday the Governor of Kansas signed into law a bill intended specifically to facilitate revenue bonds for postsecondary education loans.

Now, the significance is that this is one of the very few bills in the entire history of the Kansas Legislature which received an affirmative vote from every single member of the legislature. Every single member of the house voted in favor of that bill, and every single member of the senate voted in favor of that bill.

We did not even have an absence on the day the bill was passed by each of the two houses.

The State of Kansas does not have a reputation of being the most liberal State in the country, but the people of Kansas do recognize the importance of providing the capital which is necessary to assure that young men and women of this Nation have the opportunity to assume independent responsibility for meeting their post secondary education costs. That is what the guaranteed student loan program does.

The loan program provides the opportunity for the student to assume responsibility for meeting his or her own postsecondary education expenses and to become a more productive citizen as a result of having participated in postsecondary education and as a result of having had the financial access to that postsecondary education.

Mr. Chairman, we believe that as well intentioned as the Treasury Department proposals may be, applying these limitations and restrictions to the guaranteed student loan program revenue bonds would not be in the national interest, would not serve any useful purpose and certainly would be damaging and create some severe hardships in quite a number of States.

Thank you.

Mr. RANGEL. Thank you, Mr. Hawk.

[The prepared statement follows:]

STATEMENT OF RICHARD C. HAWK, CHAIRMAN OF THE BOARD, HIGHER EDUCATION ASSISTANCE FOUNDATION [1]

Mr. Chairman and members of the committee: There are four major reasons why the Department of the Treasury proposal to limit revenue bond tax exemption under section 103 of the Internal Revenue Code should not be applied to student loan revenue bonds.

I. The public purpose of guaranteed student loans already has been determined by the Congress and adequate limitations on revenue bonds for student loans already exist.

Student loan revenue bonds are issued for the single purpose of obtaining capital for loans to students, or to parents on behalf of students, under the Higher Education Act of 1965, as amended. The Congress has wisely determined that providing economic access to postsecondary education for all eligible citizens, without regard to state of residence, is in the national interest. Indeed, the Congress has established certain Federal subsidies to facilitate the availability of loans for eligible students in recognition of the public purpose served by providing a mechanism which permits payment of postsecondary education expenses from earnings after completion of the education.

The Treasury Department proposal for a public hearing and approval process to determine whether or not each bond issue to obtain funds for student loans serves a public purpose is at best an irrelevant procedure, creating an unnecessary expense for the states, and at worst a policy in direct conflict with the broader determination already established by the Congress.

In order to assure the propriety of student loan revenue bond issues and to provide for compliance in utilization of bond proceeds for student loans, the Congress has established specific requirements and restrictions affecting student loan revenue bonds in the Higher Education Act of 1965, as amended. The Higher Education Act requires the maintenance of a "Plan for Doing Business" with the Secretary of Education and annual audits by a certified public accounting firm to assure that bond proceeds are being utilized in accordance with the requirements and criteria specified by the Congress. There is no evidence that the imposition of additional requirements or controls is either necessary or desirable.

II. The Congress already has established a procedure for reducing Federal expenditures as an offset against any revenue loss from the tax exemption on student loan revenue bonds.

---

[1] The Higher Education Assistance Foundation serves as the student loan guarantee agency in the States of Kansas, Minnesota, Nebraska, West Virginia, Wyoming, and in Washington, D.C.

Although the Federal Government may lose some potential revenue by permitting interest on student loan revenue bonds to be exempt from Federal income tax, the Congress has already established an appropriate arrangement for a compensating reduction in Federal expenditures for subsidizing student loans. Quarterly special allowance payments by the Federal Government to holders of guaranteed student loans are reduced by 50 percent for all guaranteed student loans financed with tax exempt revenue bonds. For the quarter ended December 31, 1981, Federal special allowance payments on nine-percent loans not financed with tax exempt bonds were made at the annual rate of 7 percent, while the comparable rate for student loans financed with tax exempt revenue bonds was 3.5 percent. Substituting taxable student loan financing with the corresponding increase in Federal expenditures for special allowance payments would serve no useful purpose.

III. Limiting tax exempt revenue bonds as a source of capital for loans originated under the Federal Guaranteed Student Loan Program would deprive tens of thousands of postsecondary education students of access to loans for postsecondary education.

Any action to limit the volume of student loan revenue bonds would be counter to the national interest of providing economic access to education for all eligible citizens, because the result of reduced student loan revenue bond volume would be a significant reduction in funds available for student loans. Lack of sufficient funds for student loans translates directly into denial of economic access to postsecondary education for many eligible citizens.

If the Congress determines that student loan volume should be reduced, such reduction should be achieved through changes in eligibility requirements, maximum loan amounts, or similar provisions which would continue equal opportunity, rather than by action to limit the amount of capital for which eligible citizens would have to compete.

IV. Limiting the use of tax exempt revenue bonds as a supplementary source of capital for guaranteed student loans would penalize those States which already are encountering difficulty in generating adequate funds to meet student loan needs and would place a hardship on the residents of those States.

Some States are in the fortunate position of having sufficient capital to meet the need for guaranteed loans provided entirely by commercial lending institutions. Such fortunate States have not had to use revenue bonds for meeting student loan needs. Other States cannot meet the student loan needs of all residents entirely from funds of commercial lending institutions without a supplementary source of capital. These States have found use of revenue bonds necessary for providing economic access to education for all eligible residents.

The State of Kansas provides a convenient example. About 28 percent ($31 million) of student loans guaranteed in Kansas during fiscal year 1981 was made by the Higher Education Loan Program of Kansas, which was established in 1977 as a last resort lender to fill the gap between funds provided by commercial lending institutions and the amount needed to serve all eligible students. The gap exists in spite of a conscientious effort by commercial lending institutions to serve the needs of students while also serving substantial demand for agriculture, business, and other public and private loans. In fact, the annual volume of student loans made by commercial lenders in the State has grown from $10 million in fiscal 1977 to more than $80 million in 1981.

The proportion of the need which must be met through revenue bonds varies among the States. In fiscal 1981, it was 24 percent ($8.9 million) in West Virginia, 47 percent ($104 million) in Minnesota and 77 percent ($38 million) in the District of Columbia. For a student whose need would not have been met without capital generated from tax exempt revenue bonds the situation is critical, whether the State needs 24 or 77 percent.

The effect of the Treasury Department recommendation to require a state contribution to each student loan revenue bond issue would be to penalize those states which are already having difficulty in generating sufficient funds to meet student loan needs. Those state which are fortunate enough to be able to depend solely on capital provided by commercial lending institutions within those states would not be similarly penalized. The States of California, Indiana, Michigan, North Carolina, Oklahoma, South Carolina, and Texas—to mention just a few more—will be affected negatively by the Treasury proposal.

If the Congress determines that availability of student loans should be contingent upon a capital contribution by the state in which the citizen happens to reside, the contribution should be required through a more direct means which would not discriminate against those states which are already experiencing difficulties in generating sufficient capital to meet guaranteed student loan needs.

The Treasury proposal to eliminate arbitrage from investment earnings on bond proceeds and reserve funds would have the same effect as requiring a contribution from each State. Under current economic conditions, elimination of those investment earnings would put capital-short States in the position of either not issuing revenue bonds and not meeting the needs of all students in the State, or making a financial contribution in support of bond issues. The coupon interest rate on student loan revenue bond issue typically is in excess of 9 percent and sometimes exceeds 11 percent under current conditions. Because the assured return to the lender on a guaranteed student loan is only 9.5 percent, the lack of opportunity for earnings on investments would destroy the financial feasibility of most student loan revenue bond issues.

SUMMARY

In summary, applying the Treasury Department proposal to student loan revenue bonds is (1) irrelevant for determining the public purpose of these bond issues, because the public purpose of these single purpose bonds has already been established, (2) unnecessary to avoid a Federal revenue loss, because the Congress has already acted to offset revenues lost from tax exemption on these bonds with a specific reduction in Federal expenditures for loans financed with revenue bonds, (3) damaging to the national interest, because the proposal would reduce economic access to education and restrict opportunity for payment of expenses after completion of the education, and (4) discriminatory against those States which must either depend on revenue bonds to fill the gap between capital which can be provided by commercial lending institutions and the amount of student loan needs or permit a significant portion of the need to go unmet.

[The following was received subsequent to the hearing:]

HIGHER EDUCATION ASSISTANCE FOUNDATION

Suite 825
1001 Connecticut Avenue, N.W.
Washington, D.C. 20036
Telephone: 202-861-0707

MAY 3 1982

April 15, 1982

COMMITTEE ON
RECEIVED
APR 28 1982
WAYS AND MEANS

The Honorable Daniel Rostenkowski
2111 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Rostenkowski:

On April 6, 1982, Mr. Richard C. Hawk, Chairman of the Board of the Higher Education Assistance Foundation appeared before the Committee on Ways and Means to comment on the Treasury Department's tax proposals. Specifically, Mr. Hawk stated that the Department's proposed changes to Section 103 of the Internal Revenue Code (governing tax exempt bonds) would gravely affect the Guaranteed Student Loan Program in over 20 states. Mr. Hawk's statement is supported by the enclosed analysis of the Treasury Department's proposals on a bond issue currently being prepared for the Higher Education Loan Program of Washington, D.C.

According to the enclosed analysis the bond issue would not be financially feasible under the Treasury Department's proposals concerning limits on arbitrage. Were current arbitrage limits extended to earnings on proceeds of bond sales that are placed in reserve funds and proceeds that are held during temporary periods, debt service on the bonds could not be maintained. Therefore, the Higher Education Loan Program of Washington, D.C. and similar programs in over 20 other states could no longer issue tax exempt revenue bonds to raise capital to lend to students and parents.

This loss of capital cannot be replaced by other sources of capital and loans as explained in Mr. Hawk's April 6 statement. As a result, thousands of students in the District of Columbia and tens of thousands of students in over 20 other states would no longer have access to guaranteed student loans. A similar consequence could occur as the result of another Treasury Department proposal--requiring a 1% committment to the bond issue by states.

Hence, the Treasury Department's proposed changes to Section 103 of the Internal Revenue Code should not be applied to student loan revenue bonds.

Sincerely,

Philip R. Rever
Vice-President

Enclosure

cc: Mark Micali
John Salmon

PRR/nzb

Arbitrage
and
Student Loan Revenue Bonds

Prepared
by
Philip R. Rever
Vice President
Higher Education Assistance Foundation

April, 1982

Arbitrage and Student Loan Revenue Bonds

Philip R. Rever
Higher Education Assistance Foundation

Tax exempt revenue bonds are sold by over 20 state agencies or private non profit organizations to raise capital to subsequently make guaranteed student loans or stimulate lending by financial institutions by purchasing loans they make. Not only are the bond issuers subject to the Higher Education Act of 1965 as amended, but issuers' uses of the proceeds of the sale of the bonds are regulated by Section 103 of the Internal Revenue Code.

In early 1982, the U.S. Treasury Department proposed changes to Section 103 of the Internal Revenue Code as part of President Reagan's plan to raise federal revenues to reduce the federal deficit. Bonds issued for guaranteed student loans would be affected by the proposed changes. How the bonds would be affected by two proposed changes is examined in this paper.

The Study

Two of the Treasury Department's proposed changes affect the financing of student loan bond issues. Other proposed changes will not be examined in this paper because they are discussed in Richard C. Hawk's statements presented to the Senate Committee on Finance on March 17 and the House Ways and Means Committee on April 6.

Therefore, only two of four key changes are examined, arbitrage and financial contribution from state governments.

Arbitrage

Issuers of tax exempt student loan revenue bonds must adhere to limitations on the use of the proceeds of bond sales to avoid having the bonds declared "arbitrage bonds" thereby losing their exemption from taxes. Although the limitations are somewhat complex, each issuer has covenanted to adhere to the requirements of Section 103. Consequently, issuers typically allocate the proceeds of bond sales to three uses: (a) some portion but no more than 15% is placed in a reserve fund, (b) the greatest proportion is placed in a loan fund from which money is withdrawn as needed to make loans, and (c) to cover the underwriters' discount and the cost of issuing the bonds. Of course, monies not expended immediately are invested.

For example, monies in the reserve fund are prudently invested until needed to redeem the bonds when they mature. Similarly, monies in the loan fund are prudently invested until they are needed to make loans or to buy loans made by commercial lenders. Under current law, earnings on investments are unrestricted. Under the Treasury Department's proposals, the earnings on investments of reserve funds and loan funds could not exceed the interest paid to bond holders by more than 1½%. Obviously, issuers' plans for financing the debt service on the bonds would be affected.

The Program

To examine the effects of the proposed changes, the debt service plans of a pending bond issue were examined under two conditions. First, the debt service plan as presented in the prospectus for the bonds is described below and attached as Appendix I. Secondly, the effects of the proposed arbitrage limits were estimated and are shown in Appendix II.

Both appendices are based on a pending sale by the Higher Education Loan Program of the District of Columbia (HELP-DC). Proceeds of the $60,000,000 sale will be used to make guaranteed student and parent loans through September, 1984. HELP-DC makes three out of every four student loans in the District of Columbia. Like similar programs in many states, commercial lenders in the District do not meet the demand for loans by qualified students and parents. Therefore, the lending program plays a vital role in insuring access to guaranteed student loans.

As can be determined from a comparison of the Appendices, HELP-DC's role is dependent on unrestricted earnings from investments to maintain its debt service on the bonds as well as debt service on previously issued bonds. According to Appendix I which reflects current law, HELP-DC could meet its debt service requirements and expect a modest ($318,000) positive balance of cash and investments after the bonds are redeemed. However, under the Department's proposed changes to Section 103 as reflected in Appendix II, HELP-DC could not finance the debt service. A shortfall of over $4,000,000 would be expected. Obviously, the pending issue would be financially infeasible under the proposed changes to Section 103 even if the District of Columbia contributed 1% of the face amount of the bonds to the issue.

Although only one pending bond issue was subjected to the study of the impact of changes in arbitrage regulations, it is reasonable to conclude that issues of other similar programs would be financially infeasible. All are constrained by limits on earnings from student loans and relatively higher debt service costs. As demonstrated in this study, without unlimited earnings on investments as allowed by current law, issuers of tax free student loan bonds cannot be assured of covering the difference between earnings on student loans and cost of debt service.

Impact on Lending

Extending arbitrage limits to reserve funds and loan funds held for less than three years would have a devastating impact on access to student loans in over 20 states. Lending in other states in which commercial lending institutions can and do meet virtually all qualified borrowers' loan needs would be unaffected. Hence, access to student loans would be unfairly determined by state of residence.

Similar differences in loan availability among states could result from the Treasury Department's proposed requirement of a 1% contribution from states to tax free bond issues. Were a committment not obtained for a state, access to student loans would be reduced but only for residents of the state. Such geographical descrimination is unjust and unnecessary.

Summary

Two cash flow (debt service) projections were made for a pending bond issue to estimate the impact of the Treasury Department's proposed changes to Section 103 of the Internal Revenue Code on student loan revenue bonds. One projection, made by assuming continuation of current law that allows unrestricted investment earnings on reserves and funds held for temporary periods, estimates that debt service requirements could be met. When the same projection was made assuming changes to Section 103 of the Internal Revenue Code as proposed by the Treasury Department, debt service could not be met. In fact, a shortfall of over $4,000,000 was estimated.

The pending bond issue subjected to the cash flow projections is being issued by the Higher Education Loan Program of Washington, D.C. (HELP-DC) in the Spring of 1982. HELP-DC makes three out of every four guaranteed loans in the District of Columbia. Under the Treasury Department's proposed changes to Section 103 of the Internal Revenue Code, HELP-DC could not sell new bonds to raise capital to lend to students and parents. Similar lending programs in over 20 states would suffer the same consequences. Consequently, tens of thousands of qualified students and parents in some states would be denied access to guaranteed loans if the Treasury Department's proposed changes to Section 103 of the Internal Revenue Code were applied to student loan revenue bonds.

APPENDIX I

STAND-ALONE PROGRAM

(Series 1982A Proceeds only)

$60,000,000 HELP D.C. GSLP REVENUE BONDS
CASH FLOW PROJECTION - (000 OMITTED)

DATE: 23-Mar-82 TIME: 11:29 AM

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
					- - - - - - INTEREST	INCOME - - - - - -							
QUARTER ENDING	B.O.P. CASH & INVSTMTS	BOND PROCEEDS	LOAN SALE PROCEEDS	LOAN REPAYMTS	LOANS	RESERVES	SHORT TERM	LOAN FUND	LOANS DISBURSED	TOTAL PROGRAM COSTS	DEBT SERVICE	E.O.P. CASH & INVSTMTS	BALANCE OF LOANS
6/30/82	0	58,600	0	0	0	168	20	1,113	0	83	0	59,818	0
9/30/82	59,818	0	0	9	0	0	41	1,601	4,300	220	525	56,424	4,291
12/31/82	56,424	0	0	20	61	504	33	1,441	5,500	230	3,440	49,313	9,771
3/31/83	49,313	0	0	33	201	0	26	1,282	4,300	258	240	46,057	14,038
6/30/83	46,057	0	0	41	340	504	28	1,162	3,100	263	2,640	42,129	17,097
9/30/83	42,129	0	0	104	445	0	30	904	12,800	291	240	30,281	29,793
12/31/83	30,281	0	0	129	671	504	29	606	5,500	297	2,640	23,783	35,164
3/31/84	23,783	0	0	254	931	0	30	447	4,300	334	240	20,571	39,210
6/30/84	20,571	0	0	317	1,066	504	35	327	3,100	343	2,640	16,737	41,993
9/30/84	16,737	0	0	514	1,163	0	41	138	8,500	363	240	9,490	49,979
12/31/84	9,490	0	0	643	1,322	504	54	0	0	128	2,640	9,245	49,336
3/31/85	9,245	0	0	1,137	1,425	0	78	0	0	141	240	11,504	48,199
6/30/85	11,504	0	0	1,218	1,397	504	112	0	0	142	2,640	11,953	46,981
9/30/85	11,953	0	0	1,563	1,365	0	151	0	0	143	240	14,649	45,418
12/31/85	14,649	0	43,644	1,774	2,417	504	96	0	0	126	62,640	318	0
TOTALS		58,600	43,644	7,756	12,804	3,696	804	9,021	51,400	3,362	81,245		

ASSUMPTIONS

BEG. CASH & INVESTMENTS:	0
BEG. LOAN VOLUME:	0
VARIABLE RATE BONDS:	12,000
NEW ISSUE SIZE:	60,000
NEW RESERVE:	7,200
COST OF ISSUANCE:	200
DISCOUNT:	1,200
CAPITALIZED INTEREST:	0
LOANS:	51,400

12/31/85 FINAL BALANCE:	318
PLUS LOANS REMAINING:	0
LESS BONDS OUTSTANDING:	0
NET FUND BALANCE:	318

INTEREST RATES

NEW BOND ISSUE:	10.00%
NEW RESERVE:	14.00%
LOAN FUND:	13.00%
SHORT-TERM:	10.00%
LOAN INCOME:	11.49% (WEIGHTED AVERAGE)

VARIABLE RATE FACTOR:	80.00%
RESULTANT AVERAGE RATE:	8.00%
FIRST PERIOD RATE:	10.50%
ALAS LOANS,% OF VOLUME:	10.00%
BEGINNING WITH QUARTER	0

APPENDIX II

STAND-ALONE ISSUE

(Investments limited to 9.6%)
(Accrued interest added)

$60,000,000 HELP D.C. GSLP REVENUE BONDS
CASH FLOW PROJECTION - (000 OMITTED)

DATE: 14-Apr-82 TIME: 09:22 AM

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
					- - - - - - INTEREST		INCOME - - - - - -						
QUARTER ENDING	B.O.P. CASH & INVSTMTS	BOND PROCEEDS	LOAN SALE PROCEEDS	LOAN REPAYMTS	LOANS	RESERVES	SHORT TERM	LOAN FUND	LOANS DISBURSED	TOTAL PROGRAM COSTS	DEBT SERVICE	E.O.P. CASH & INVSTMTS	BALANCE OF LOANS
6/30/82	0	58,600	0	0	0	115	61	775	0	83	0	59,468	0
9/30/82	59,468	0	0	9	0	0	97	1,110	4,300	220	525	55,639	4,291
12/31/82	55,639	0	0	20	61	346	77	992	5,500	230	3,440	47,965	9,771
3/31/83	47,965	0	0	33	201	0	59	875	4,300	258	240	44,335	14,038
6/30/83	44,335	0	0	41	340	346	51	786	3,100	263	2,640	39,896	17,097
9/30/83	39,896	0	0	104	445	0	43	595	12,000	291	240	27,752	29,793
12/31/83	27,752	0	0	129	671	346	35	376	5,500	297	2,640	20,872	35,164
3/31/84	20,872	0	0	254	931	0	29	258	4,300	334	240	17,470	39,210
6/30/84	17,470	0	0	317	1,056	346	27	169	3,100	343	2,640	13,312	41,993
9/30/84	13,312	0	0	508	1,163	0	28	66	5,500	356	240	8,981	46,985
12/31/84	8,981	0	0	637	1,278	346	37	0	0	122	2,640	9,517	46,348
3/31/85	9,517	0	0	1,128	1,339	0	57	0	0	134	240	10,667	45,220
6/30/85	10,667	0	0	1,212	1,311	346	84	0	0	136	2,640	10,844	44,008
9/30/85	10,844	0	0	1,530	1,280	0	117	0	0	135	240	13,396	42,470
12/31/85	13,396	0	40,713	1,765	2,261	346	23	0	0	118	62,640	-4,254	0
TOTALS		58,600	40,713	7,687	12,347	2,537	825	6,002	48,400	3,320	81,245		

ASSUMPTIONS

BEG. CASH & INVESTMENTS:	0
BEG. LOAN VOLUME:	0
VARIABLE RATE BONDS:	12,000
NEW ISSUE SIZE:	60,000
NEW RESERVE:	7,200
COST OF ISSUANCE:	200
DISCOUNT:	1,200
CAPITALIZED INTEREST:	3,000
LOANS:	48,400

12/31/85 FINAL BALANCE:	-4,254
PLUS LOANS REMAINING:	0
LESS BONDS OUTSTANDING:	0
NET ASSET BALANCE:	-4,254

INTEREST RATES

NEW BOND ISSUE:	10.00%
NEW RESERVE:	9.60%
LOAN FUND:	9.60%
SHORT-TERM:	9.60%
LOAN INCOME:	11.49% (WEIGHTED AVERAGE)

VARIABLE RATE FACTOR:	80.00%
RESULTANT AVERAGE RATE:	8.00%
FIRST PERIOD RATE:	10.50%
ALAS LOANS,% OF VOLUME:	10.00%
BEGINNING WITH QUARTER	0

Mr. **Frenzel**. Mr. Chairman.

Mr. **Rangel**. I recognize the gentleman from Minnesota.

Mr. **Frenzel**. Because I may not be here for some of the panels, I would like to submit questions. I ask unanimous consent that I may enter those questions in the record.

Mr. **Rangel**. Without objection.

Mr. Smith, financial vice president of Boston College.

STATEMENT OF JOHN R. SMITH, VICE PRESIDENT FOR FINANCIAL AFFAIRS AND TREASURER, BOSTON COLLEGE

Mr. **Smith**. Thank you very much.

I am the vice president and treasurer of Boston College, and chief financial officer. In addition to that, I am also a member of the Massachusetts Health and Educational Facilities Authority which issues bonds for financing college building construction.

I am also a member of the Massachusetts College Student Loan Authority, which expects to sell bonds for financing loans to students. I am also a director of the Massachusetts Higher Education Assistance Corp. which provides guarantees for student loans.

The reason for describing all these financing plans is our supreme concern about any drop in student volume. My description of the problem today is as a person who came into college financing after 20 years of industry. Many colleges went bankrupt; ours in particular was absolutely bankrupt but held on. The principal reason for that is it was not allowed to accumulate reserves of any size.

We describe ourselves as an unendowed independent college. Because of that, we keep the tuition as low as we can, the budget every year is aimed at break even. We have students on the budget committee, members of the faculty, and the entire process is to operate at minimum cost.

We are here to express our interest in the continued availability of tax-exempt bonds financing for our insitution and for all universities in the United States, because we believe that such financing is vital for their very survival. Survival is the financial problem here.

Even large heavily endowed colleges face the same problem. The independent college with a small endowment has costs which must be met by two principal forms of revenue: Charges to students for tuition, room and board, and by modest private gifts from various sources.

In Boston College, 98 percent of our gross revenues come from tuition, room and board, and 2 percent from gifts or earnings on prior gifts. But with the administration suggesting that the Federal student assistance program be drastically reduced or totally eliminated, the future prospects are indeed threatening to students whose opportunities or choices can become severely restricted if available at all.

In 1980, Congress amended the Higher Education Act of 1965 and in the process Congress made a finding and found among other things, that it is the responsibility of the Federal Government and institutions of higher education to promote equality of access to postsecondary education, freedom of choice to students, quality of postsecondary education, and the efficient use of resources in postsecondary education. The optimal allocation of human and physical and financial resources through efficient planning and management achieve these goals.

Now, independent colleges who have little or no endowment must maintain a balanced budget every year, including the payment of debt service. The fixed expense element of colleges is very high. Some elements are variable and can be reduced over 2, 3, or 4 years, such as the problem of staff. Buildings in the process of repayment could be sold if necessary.

The net result of a sudden change in any part of this financial algorithm as it would be sometimes with a college or hospital is that your immediate deficit is the negative cash flow. This means you are unable to pay your bondholders and the whole paper pile will collapse.

Bondholders become nervous and disinclined to buy bonds if threats to student financial aid, building funding, as well as student loan funds are limited to ephemeral or short-term planning. The Higher Education Act of 1965 specified and placed the responsibility both on the Federal Government and on the postsecondary education institutions to efficiently plan and manage.

Colleges have planned on the basis of continued Federal student aid and construction grants continuing from the Federal Government. Now, they must react as specified in the Higher Education Act as amended to adapt themselves to changing conditions.

So the colleges and the hospitals are attempting to manage under the current plan changes. Some of the student loan bonds are contemplated as taking the place of Federal student aid and grant programs and Federal student loan subsidies. In Massachusetts, our Governor signed into law the Massachusetts College Student Loan Authority. The independent colleges as well as the State universities are relying on these loans as a supply of funds for students in school status, to be repaid after graduation.

This is an effective plan for colleges and States to adapt to the New Federalism concept. With the decline and demise of HUD and HEW grants and loans to colleges, State legislators established facility bond authorities. These authorities have sold bonds to replace energy-inefficient facilities, to modify facilities because of changing demographic and economic and social changes, and to build academic facilities to insure continued accreditation of colleges.

We wish to point out that the not-for-profit organizations which may use tax-exempt bond financing have different purposes than all others. Nonprofit organizations such as colleges, universities, and hospitals are granted tax exemption under 501(c)(3) of the Internal Revenue Code.

The ultimate beneficiaries of the tax-exempt bond issues used by not-for-profit institutions are students in the case of colleges, and patients, in the case of hospitals. The beneficiaries of tax-exempt issues used for business are the shareholders of such businesses who, under present tax law, also benefit from accelerated depreciation on assets acquired through such issues.

We would recommend therefore that the committee give consideration to amending the arbitrage regulation to permit section

501(c)(3) institutions to be exempted from restrictions now imposed upon them.

[The prepared statement follows:]

STATEMENT OF JOHN R. SMITH, FINANCIAL VICE PRESIDENT AND TREASURER, BOSTON COLLEGE, CHESNUT HILL, MASS.

I am John R. Smith, Vice President and Treasurer of Boston College; with me is my colleague, Francis F. Mills, Director of Financial Planning for the College.

In addition to my specific college duties, the Governor of Massachusetts appointed me a member of the Massachusetts Health and Educational Facilities Authority, and recently appointed me a member of the Massachusetts College Student Loan Authority. I am also a Director of the Massachusetts Higher Education Assistance Corporation.

Mr. Mills is also a member of the Executive Committee of the Massachusetts Association of Non-Profit Schools and Colleges.

In terms of independent college student enrollments, Massachusetts ranks second only to the State of New York.

Boston College is one of the largest Catholic Colleges in the United States.

We have submitted our prepared testimony to your staff, and ask that it become part of the record of this hearing. These two Massachusetts Authorities assist hospitals and colleges by selling tax-exempt bonds to help hospitals contain interest costs; to help colleges minimize tuition; to help students currently finance postsecondary education to be repaid after graduation; and to help the Federal Government by lessening the expenditures for financial aid by 50% for special allowances and the in-school subsidies of interest on Guaranteed Student Loans.

We are here to express our interest in the continued availability of tax-exempt bond financing for non-profit, independent colleges and universities in the United States because we believe that such financing is vital for their very survival.

All independent colleges, including those with large endowment funds, are struggling to cope with rising costs in all forms; costs which must be borne by already heavily burdened students and their families.

For the independent college with a small endowment fund, costs must be met by only two principal forms of revenue; charges to students for tuition, room and board, and by modest private gifts from various sources.

With the Administration suggesting that Federal Student Assistance programs be drastically reduced or totally eliminated, the future prospects are indeed threatening to students whose opportunities or choices can become severely restricted, if available at all.

We believe that such opportunity and choice are vital to the future of the United States in terms of preserving the quality of American life, our economy, the development of technological skills, and our leadership in the world.

The importance of postsecondary education to the national interest in a hostile world was recognized by the Congress in 1959 when it enacted the National Defense Student Loan Program.

This first student assistance program, with an initial appropriation of $31 million, has developed to the point where, at June 1980, over $7.6 billion had been loaned to over 11.5 million students. These loans are being recycled for the benefit of current and future students. The Administration now proposes that no further appropriations be made.

Other programs followed - Pell Grants, Supplemental Grants, Work Study, etc., plus Federally Guaranteed Student Loans. The Administration now proposes that Pell Grants be reduced, Supplemental Grants be eliminated, and Work Study also reduced. We mention these programs in the context of the proposed elimination or reduction in the availability of tax-exempt bond financing for colleges and universities, in order to make the point that the interest savings inherent in such financing are another significant form of student assistance which is of great importance to the future of higher education.

Interest costs connected with financing of college academic and other facilities are real elements of expense which must be currently paid for in cash and imposed upon students dollar for dollar.

Thus, lower interest rates directly result in lower costs to be imposed on students. Lower costs provide more students with educational opportunity, freedom of choice, and access.

The Administration is proposing serious reductions and modifications in the Guaranteed Student Loan Program which will effectively eliminate the participation in the program of sbustantial numbers of students.

Newly-created State Student Loan programs are intended to provide a partial substitute for the Federal Guaranteed Student Loan programs. Without tax-exempt bond financing, these State programs will never get off the ground. Interest rates charged on unsecured commercial loans would be at a prohibitive 20%.

Two states, Illinois and Massachusetts, have already enacted legislation. These Acts allow colleges to borrow student loan capital, raised in the private capital markets without Federal guarantees or insurance, so that loans can be made available to college students. These laws represent creative and timely responses to the sharp reductions in overall Federal student financial aid. A crucial element of these laws, which make the student loans affordable to the students, is the tax-exempt feature of the underlying revenue bonds.

These tax-exempt loans relieve the Federal budget of interest costs and special allowances for loans which are now guaranteed by the Department of Education.

If there have been abuses and excesses in the use of tax-exempt bonds, they have not been in education. The Federal deficit can be lowered by cutting tax expenditures, but please do not eliminate ALL tax expenditures occasioned by tax-exempt bonds. Higher education and the students are "on the ropes."

Urgently needed student loan capital and capital for future construction of academic facilities will be lost if the tax-exempt feature of bonds issued for these purposes is eliminated.

As we read the Treasury proposals which were released on February 26, 1982 we were concerned by language which combined small issue IDB's, IR Bonds and "not-for-profit" tax-exempt bonds as though they all had the same purpose and beneficiaries.

There is a distinct difference between those businesses which issue tax-exempt bonds and Section 501(C)(3) institutions which issue such bonds.

We wish to point out that the not-for-profit, private organizations which may use tax-exempt bond financing, have a different purpose and different beneficiaries than all others.

Non-profit organizations, such as colleges, universities and hospitals, are granted tax exemption under Section 501(C)(3) of the Internal Revenue Code.

The beneficiaries of tax-exempt bond issues used by not-for-profit Section 501(C)(3) institutions are students (in the case of colleges), and patients (in the case of hospitals.)

The beneficiaries of tax-exempt issues used for businesses are the shareholders of such businesses, who, under present tax law also benefit from accelerated depreciation on assets acquired through such issues.

We would recommend, therefore, that the Committee give consideration to amending the arbitrage regulations to permit Section 501(C)(3) institutions to be exempted from restrictions now imposed upon them.

Mr. RANGEL. Any questions from the committee? Oh, I am sorry, Mr. McFarland.

STATEMENT OF PAUL G. McFARLAND, VICE PRESIDENT FOR FINANCE, LOYOLA UNIVERSITY OF CHICAGO

Mr. McFARLAND. Members of the committee, it is a pleasure to be here on behalf of Loyola University.

I will in the next few minutes discuss the following points: The importance of tax-exempt bonds to Loyola University and to higher education in general; the inclusion of colleges, universities, and teaching hospitals in the proposal; and the appropriateness of proposed regulations.

Simply put, the administration's tax-exempt bond proposal targeted at private activities could have costly effects for America's private colleges and universities and teaching medical centers. These tax revisions could lead to higher debt service costs, and, therefore, higher tuition, just at the time institutions of higher education are facing Federal cutbacks in aid, reduced tax incentives for private giving, changed demographic conditions, and escalating expenses.

This increase in debt service costs could harm America's private universities, in general, and Loyola, in particular. The proposals could lead to a general rise in the cost of debt service for the Nation's private universities by reducing investment earnings on the proceeds of the bond issues during construction, and thereby increasing the cost of building and renovating dormitories, student centers, and hospitals.

At current interest rate levels, which we all know are having an extremely negative effect on the overall economy, it is estimated that the Treasury Department's revisions would increase the cost of construction, renovation, and deferred maintenance by approximately a 6-percent investment.

This increase in the cost of building and renovating facilities means the size of the bond issue must be enlarged in order to complete the project. Larger bond issues would result in more funds being dedicated to debt service, thus necessitating higher tuition or reallocation of scarce resources from educational programs.

Tax-exempt bond financing is extremely important to Loyola University and to other colleges and universities as well. Twenty percent of the total dollar volume of student loans rely on tax-exempt bond financing. More that 24 States issue bonds as a way of assuring loan certainty to students eligible for the Federal guaranteed student loan program.

A new loan program is being developed in several States to fill in the gap for moderate and middle-income families who cannot obtain loan funds from other sources. These college-backed loans receive no Federal guarantee or subsidy, other than tax-exempt borrowing. Independent and public colleges and universities utilize tax-exempt bonds to finance construction and renovation of facilities such as dormitories, student union buildings, and teaching hospitals.

In 1981, 73 bond issues were offered totaling $1.2 billion. The cost of raising capital through other means would have been prohibitive in many cases.

The revisions could especially affect Loyola because they might jeopardize a very innovative financing program that we developed over the past 2 years using tax-exempt commercial paper. As you know, commercial paper has long been used by businesses to reduce the cost of interim financing. This technique has recently been employed by public sector borrowers because of the heavy demand for such securities, and because of the high cost of long-term debt.

In this connection, I might point out that while interest rates on 30-year taxable Government bonds have increased 4.7 percent in the past year, the bond buyer index for municipal bonds has risen 29.2 percent, reducing the traditional spread between tax-exempt and taxable bonds from 66.66 percent of the taxable rate to 90 percent and further increasing the cost of providing vital public services.

Loyola University of Chicago has been a leader in developing that response. Indeed, at the present, we have $56.4 million of short-term commercial paper outstanding, one of the largest tax-exempt programs of this type in the Nation. During the time since we started the program, the average cost of funds has been approximately 7.5 percent, or an average of about 5 percentage points below the median of the bond buyer index during that period.

As a result, we were able to increase the investment spread and generate savings for the university. This program helped us keep tuition increases for the coming academic year to 10.3 percent, when most comparable universities were raising their rates by 12 to 17 percent.

In view of our success with commercial paper, we would have expected the administration to encourage, rather than discourage, such programs. However, according to a preliminary interpretation of the proposed tax revisions by the Treasury Department, the investment spread resulting from our program would be eliminated after December 31. The new approval processes proposed would be particularly onerous due to the fact that the commercial paper has an average issue life of 36 days and approximately $10 million is reissued weekly.

The proposed revisions seem to be a mistake not only from the standpoint of increasing costs to colleges and universities, but also from the standpoint of public policy. The administration incorrectly includes colleges and universities within its proposal for limiting the private activity use of tax-exempt bond financing.

Traditionally, privately sponsored education and health care have provided public benefits in this country. The provisions of the Internal Revenue Code, as well as the requirements of the not-for-profit Corporation Act of the various States under which most qualifying charitable, education, and health-care organizations are incorporated, expressly preclude private benefit from their operation.

For that reason, universities and their medical centers have been able to use tax-exempt financing. We see no real distinction between public and private institutions in that connection; both provide a public benefit and accordingly they should enjoy the same status under the Tax Code.

Indeed, with the already existing tuition gap between public and private higher education, we can only see these revisions increasing the gap and thereby reducing the competition between public and private higher education. Serious competitive imbalances between independent and public colleges could result should this distinction stand.

Finally, the nature of the restrictions proposed by Treasury underscores the inappropriateness to higher education. The proposal is silent on the effect of its provisions on Federal education policy. Restrictions have not taken into account the substantial changes and cutbacks in Federal education funding for college students, nor the expected impact on charitable giving due to the Economic Recovery Tax Act of 1981.

The requirement of a financial contribution of 1 percent by State or local governments is neither realistic tax policy nor good education policy. Many State constitutions, as we have heard before, prohibit such contributions to independent colleges and universities. Many hard-pressed units of Government cannot afford to make additional financial contributions to higher education.

A requirement for a public hearing and approval by the higher elected official per issue will greatly limit the flexibility in timing the bond sales and create extraordinary delays in securing bond proceeds.

In summary, therefore, it appears to us that the administration has taken the opposite approach from the one required by present circumstances. Instead of moving to support America's independent universities at a time when so many factors are working against them, it has announced revisions in the code that would strengthen these negative forces.

Indeed, the changes would eviscerate one of the most important programs that Loyola has developed for reducing costs and mitigating tuition increases. The Nation's well-being has been contributed to by many men and women educated in private colleges and universities. The well-being of these colleges and universities must be maintained and strengthened.

We urge the Congress to resist these changes and to help, rather than hinder, our independent colleges and universities.

Mr. RANGEL. Thank you, Mr. McFarland.

[The prepared statement follows:]

STATEMENT OF PAUL G. MCFARLAND, LOYOLA UNIVERSITY OF CHICAGO

SUMMARY

The Department of Treasury's proposed changes to Section 103 of the Internal Revenue Code should not be applied to colleges and universities and teaching medical centers for the following reasons:

I. The importance of tax-exempt bonds to Loyola University and higher education in general. These tax revisions could lead to higher debt service costs, and, therefore, higher tuition, just at the time institutions of higher education are facing federal cut-backs in aid, reduced tax incentives for private giving, changed demographic conditions and escalating expenses.

II. The administration incorrectly includes colleges and universities within its proposal for limiting the "private activity" use of tax-exempt bond financing. Traditionally, education and health care have been viewed as providing public benefits in this country. We see no real distinction between public and private institutions in this connection; both provide a public benefit and accordingly they should enjoy the same status under the tax code. Serious competitive imbalances between independent and public colleges could result should this distinction stand.

III. The nature of the restrictions proposed by Treasury underscores the inappropriateness to higher education. The requirement of a financial contribution is neither realistic tax policy nor good education policy. Many state constitutions prohibit such contributions to independent colleges and universities. Many hard pressed units of government cannot afford to make additional financial contributions to higher education. For educational facilities these commitments could take the form of tax abatements. Yet no such option is proposed for student loan bonds. A requirement for a public hearing and approval by the highest elected official per issue will greatly limit the flexibility in timing the bond sales and create extraordinary delays in securing bond proceeds.

STATEMENT

It is a pleasure to be here today on behalf of Loyola University of Chicago, a private institution of higher education. I will, in the next few minutes, discuss the following points: (1) the importance of tax-exempt bonds to Loyola University and higher education in general; (2) the inclusion of colleges and universities and teaching medical centers within the Treasury proposal for limiting the "private activity" use of tax-exempt financing; and (3) the inappropriateness of the proposed restrictions on higher education.

Simply put, the administration's tax-exempt bond proposal targeted at private activities could have costly effects for American's private colleges and universities and teaching medical centers. These tax revisions could lead to higher debt service costs, and, therefore, higher tuition, just at the time institutions of higher education are facing federal cut-backs in aid, reduced tax incentives for private giving, changed demographic conditions and escalating expenses.

This increase in debt service costs could harm America's private universities, in general, and Loyola, in particular. The proposals could lead to a general rise in cost of debt service for the Nation's private universities by reducing investment earnings on the proceeds of the bond issues during construction and thereby increasing the cost of building and renovating dormitories, student centers and hospitals. At current interest rate levels, which we all know are having an extremely negative effect on the overall economy and thus on institutions of higher education, it is estimated that the Treasury Department's revisions would increase the cost of constructions, renovation and deferred maintenance by approximately 6 percent, assuming a 3-year construction period and a 2 percent investment spread. This increase in the cost of building and renovating facilities means the size of the bond issue must be enlarged in order to complete the project. Larger bond issues would result in more funds being dedicated to debt service, thus necessitating higher tuition or reallocation of scarce resources from educational programs to interest expense.

Tax-exempt bond financing is extremely important to Loyola University and to other colleges and universities as well. Twenty percent of the total dollar volume of student loans made in the nation rely on tax-exempt bond financing. More than 24 States issue bonds as a way of assuring loan certainty to students eligible for the Federal Guaranteed Student Loan Program. A new loan program, supplemental to GSL, is being developed in several states to fill in the gap for moderate and middle income families who cannot obtain loan funds from other sources. These college-backed loans receive no Federal guarantee or subsidy, other than tax-exempt borrowing. In the first 10 months of 1981, independent and public colleges and universities utilized tax-exempt bonds to finance construction and renovation of facilities such as dormitories, student union buildings and teaching hospitals. Seventy-three bond issues were offered totaling $1.2 billion. The cost of raising capital through other means would have been prohibitive in many cases. Nonprofit organizations do not have the same access to other forms of capital and unique financial arrangements utilized by for-profit organizations.

The revisions could especially affect Loyola because they might jeopardize a very innovative financing program that we developed in the past 2 years, tax-exempt commercial paper. As you know, commercial paper has long been used by businesses to reduce the cost of interim financing. This technique has recently been employed by public sector borrowers because of the heavy demand for such securities on the part of tax-exempt money market funds and because of the high cost of long-term debt. In this connection, I might point out that while interest rates on 30-year taxable Government bonds have increased 4.7 percent in the past year, the Bond Buyer

Index for municipal bonds has risen 29.2 percent, reducing the traditional spread between tax-exempt and taxable bonds from 66⅔ percent of the taxable rate of 90 percent and further increasing the cost of providing vital public services. As I indicated, tax-exempt commercial paper is primarily a response to the higher level of interest rates.

Loyola University of Chicago has been a leader in developing that response. Indeed, at the present, we have $56.4 million of short-term commercial paper outstanding, one of the largest tax-exempt programs of this type in the nation. During the time since we started the program, the average cost of funds has been approximately 7.5 percent or an average of about 5 percentage points below the median of the Bond Buyer Index during that period. As a result, we were able to increase the investment spread and generate savings for the University. Indeed, this program helped us keep tuition increases for the coming academic year to 10.3 percent, when most comparable universities were raising their rates by 12 to 17 percent.

In view of our success with commercial paper, we would have expected the administration to encourage, rather than discourage, such programs. However, according to a preliminary interpretation of the tax revisions proposed by the Treasury Department, the investment spread resulting from our program would be eliminated after December 31 if the changes were adopted and the new approval processes proposed would be particularly onerous due to the fact that the commercial paper has an average issue life of 36 days and approximately $10 million is reissued weekly.

The proposed revisions seem to be a mistake not only from the standpoint of increasing costs to colleges and universities, but also from the standpoint of public policy. The administration incorrectly includes colleges and universities within its proposal for limiting the "private activity" use of tax-exempt bond financing. Traditionally, privately sponsored education and health care provided public benefits in this country. The provisions of the Internal Revenue Code, as well as the requirements of the not-for-profit Corporation Act of the various states under which most qualifying charitable, education, and health care organizations are incorporated, expressly preclude private benefit from their operation. For that reason, universities and their medical centers have been able to use tax-exempt financing. We see no real distinction between public and private institutions in that connection; both provide a public benefit and accordingly they should enjoy the same status under the tax code. Indeed, with the already existing tuition gap between public and private higher education, we can only see these revisions increasing the gap and thereby reducing the competition between public and private higher education. Serious competitive imbalances between independent and public colleges could result should this distinction stand.

Finally, the nature of the restrictions proposed by Treasury underscores the inappropriateness to higher education. The proposal is silent on the effect of its provisions on Federal education policy. Restrictions have not taken into account the substantial changes and cut backs in Federal education funding for college students, nor the expected impact on charitable giving due to the Economic Recovery Tax Act of 1981. The requirement of a financial contribution of 1 percent by State or local governments is neither realistic tax policy nor good education policy. Many State constitutions prohibit such contributions to independent colleges and universities. Many hard pressed units of government cannot afford to make additional financial contributions to higher education. For educational facilities these commitments could take the form of tax abatements. Yet no such option is proposed for student loan bonds. A requirement for a public hearing and approval by the highest elected official per issue will greatly limit the flexibility in timing the bond sales and create extraordinary delays in securing bond proceeds.

In summary, therefore, it appears to us that the administration has taken the opposite approach from the one required by present circumstances. Instead of moving to support America's independent universities at a time when so many factors are working against them, it has announced revisions in the code that would strengthen these negative forces. Indeed, the changes would eviscerate one of the most important programs that Loyola has developed for reducing costs and mitigating tuition increases. The Nation's well-being has been contributed to by many men and women educated in private colleges and universities. The well-being of these colleges and universities must be maintained and strengthened. We urge the Congress to resist these changes and to help, rather than hinder, our independent colleges and universities.

Mr. RANGEL. Mr. Bohen.

STATEMENT OF FREDERICK M. BOHEN, VICE PRESIDENT FOR FINANCE AND OPERATIONS, UNIVERSITY OF MINNESOTA

Mr. BOHEN. I am here on behalf of the land-grant institution where I work, the University of Minnesota, and many other public and private institutions, to express our concern about possible adjustments to both the individual and corporate minimum tax provisions of the Internal Revenue Code as they might affect charitable giving.

At Minnesota I oversee a major program of fundraising from private sources that provides an absolutely critical supplement to the Federal funds appropriated by the State of Minnesota for the conduct of university activities. During 1980–81, the university raised $49.8 million in private support for university operations, an achievement that placed us No. 3 in the Nation amongst all universities in voluntary support for our programs.

Substantially more than half of this amount was provided by individual givers and private corporations. Although a formal proposal is not currently before your committee, we anticipate suggestions that would restructure the existing minimum tax on both individuals and corporations in a way to increase the existing tax on individual donations, and establish a minimum tax on corporate gifts to charity.

In both cases, the possible changes would increase the costs of a dollar of charitable giving from $1 to a $1.15. This would be accomplished by designating the full deduction for charitable giving as a tax preference item, adding it to the minimum tax base and subjecting the sum to a 15-percent rate.

We strongly believe that any proposal along these lines derives from a faulty premise that private funds voluntarily provided for charity should be subject to taxation. To be sure, the existing minimum tax on individuals, estates and trusts, already touches gifts to charity if those gifts plus several other itemized deductions exceed 60 percent of the adjusted gross income of the taxpayer.

Economic analysis prepared at the time this alternative minimum tax was under consideration by the Congress strongly suggested that individual donations to colleges and universities would be reduced through enactment of the proposal. Because, however, the charitable sector concluded that all taxpayers should, in fact, pay some tax, we accepted some reduction in charitable giving to accomplish this goal.

I understand that a recent computer count of the 1977 Treasury tax file shows, in fact, that the existing provision is effective. Wealthy citizens no longer appear to be avoiding any taxation through charitable giving. This surely raises the question, if existing law is working, why increase the tax penalty on donor generosity.

It would seem that the only other reason to increase the tax on charitable giving would be to increase Federal revenues. But does it really make sense to attempt to ease this country's severe budgetary problems through this form of taxation?

A proposal along these lines simply adds a tax on those considering a donation of private support for services that benefit the community at large. In effect, it is a voluntary tax on one's own generosity.

On Federal spending questions, I understand that many of you have expressed concern that the budget cuts in programs similar to those advanced by charitable giving have gone far enough. To adopt an increased tax on charitable giving would have the same effect that you seek to avoid on the spending side of the budget.

The decrease in charitable giving can only produce a commensurate decrease in the services that charitable organizations provide. This result would be particularly unfortunate at a time when retrenchment of public programs at all levels of our society has forced Americans more than ever to seek assistance from charitable sources.

With respect to the possible inclusion of corporate donations in any minimum tax structure, it is hard to find a policy rationale or objective that would justify or explain such a decision. In light of the number of dollars corporate giving represents, it seems unlikely that either revenue raising or loophole closing can be the excuse for such a step.

The amount of giving by corporations remains small in comparison to giving by individuals, only 5.2 percent of the total or about $2 billion. Thus it seems an unlikely source for increasing Federal revenues.

However, corporate giving is regarded by many as having important potential for funds to help fill the gap of funds that have been lost by the curtailment of both Federal and State public service programs, and by recent changes in Federal tax law that may create disincentives for individual gifts.

For example, gifts to the University of Minnesota from private corporations have, over the last 4 years, more than doubled. Moreover, through provisions of the Economic Recovery Tax Act of 1981, Congress recently reduced corporate tax incentives to give by, in effect, reducing the number of corporations who have or will have taxable income.

As you know, corporations are limited to deductions for charitable giving up to but not above 10 percent of corporate taxable income.

The apparent effect of these recent tax changes for those new corporations that contribute the maximum to charity may in fact be a lowering of the amount of gifts that can be provided under this 10-perent ceiling.

Thus, at a time when a major governmental theme urges private sector involvement in meeting national needs and the private sector in many areas is awakening to this opportunity, the tax incentive to make those gifts may now be somewhat less attractive and available to a smaller number of donors.

In summary, we strongly urge this Ways and Means Committee to oppose any tax increases on charitable giving. We believe that the charitable sector has already been hit hard over the last year through two rounds of public spending cuts and the Economic Recovery Tax Act of 1981.

We hope that there are other ways to solve the Nation's severe budgetary problem than the ways that would create a further financial drain on the vitality of the not-for-profit sector.

[The prepared statement follows:]

STATEMENT OF VICE PRESIDENT FREDERICK M. BOHEN, UNIVERSITY OF MINNESOTA, ON BEHALF OF AMERICAN ASSOCIATION OF STATE COLLEGES AND UNIVERSITIES; AMERICAN COUNCIL ON EDUCATION; ASSOCIATION OF AMERICAN UNIVERSITIES; ASSOCIATION OF CATHOLIC COLLEGES AND UNIVERSITIES; ASSOCIATION OF JESUIT COLLEGES AND UNIVERSITIES; NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS; NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES; AND NATIONAL ASSOCIATION OF STATE UNIVERSITIES AND LAND-GRANT COLLEGES

Dear Mr. Chairman: My name is Frederick M. Bohen. I am Vice President for Finance and Operations of the University of Minnesota. In this capacity, I oversee the conduct of a major program of fundraising from private sources that provides an absolutely critical supplement to the public funds appropriated by the state of Minnesota for the conduct of our far-flung university activities. During 1980–81, the University of Minnesota raised $49.8 million in private support for university operations, an achievement that placed us number three in the nation amongst all public universities in voluntary support for our programs.

I am pleased to express our concern about possible adjustments to both the individual and corporate minimum tax provisions of the Internal Revenue Code. I find myself in a somewhat awkward position in addressing this Committee at this time on this subject, since my testimony does not address an existing proposal, but rather is the result of indications that a proposal will be presented to the Senate Finance Committee that would restructure the existing minimum tax on both individuals and corporations in a way that will increase the existing tax on individual donations and establish a minimum tax on corporate gifts to charity.

We have been given reason to believe that in both cases the proposed changes would increase the cost of a charitable donation from $1 to $1.15. This would be accomplished by designating the full deduction for charitable giving as a tax preference item, adding it to the minimum tax base and subjecting the sum to a 15-percent rate.

However, the details of these proposals are actually irrelevant to this discussion, since the above calculation or any other scheme of similar purpose is founded on a false premise—that income donated to a charity should be subject to taxation. I strongly urge this committee to oppose any proposal that would increase the existing disincentives for individuals and corporations to donate their wealth to charity. Please let me explain.

As you know, the existing minimum tax on individuals, estates, and trusts already reaches gifts to charity if those gifts plus several other itemized deductions exceed 60 percent of the adjusted gross income of the taxpayer.

Economic analysis prepared at the time this alternative minimum tax was under consideration strongly suggested that individual donations to colleges and universities would be reduced by enactment of the proposal. However, because the charitable sector agrees that all taxpayers should pay some tax, we agreed to some reduction in giving to accomplish this goal. And in fact a recent computer count of the 1977 Treasury tax file shows that the existing provision does prevent taxpayers from avoiding taxation through charitable giving. This computer scan indicates that thousands of upper income donors to charity were constrained by the alternative minimum tax. This surely raises the question, if existing law works, why increase the tax penalty on donor generosity? It would seem that the only other reason for increasing the tax on giving would be to increase Federal revenues. But does it really make sense to attempt to ease this country's budgetary problems through this form of taxation? This would impose a tax on those who have made an affirmative decision to donate private support for services that benefit the community at large—in effect a true voluntary tax on one's own wealth.

On Federal spending questions I understand that many of you have expressed concern that the budget cuts that support programs similar to those advanced by charity have gone far enough. To adopt an increased tax on charitable giving would have the same effect that you seek to avoid on the spending side of the budget. A decrease in charitable giving can only produce a commensurate decrease in the services that charitable organizations can provide. This result would be particularly unfortunate at a time when Federal retrenchment has forced Americans more than ever to seek assistance from charitable sources.

With regard to the proposed inclusion of corporate donations in any minimum tax structure, I simply fail to perceive the policy rationale or objective that supports such a decision. In light of the number of dollars corporate giving represents, it seems unlikely that either "loophole" closing or revenue raising can be the excuse for such a step. After all, the amount of giving by corporations is small in comparision to giving by individuals: $2.055 billion (or 5.2 percent of total giving). Thus, it seems an unlikely source for increasing Federal revenues. However, corporate giving is regarded by many as an important potential for funds to help fill the gap of funds that have been lost by the curtailment of both Federal and state public programs and by recent changes in the tax laws that appear to create significant disincentives for individual giving.

Further, through provisions of the Economic Recovery Tax Cut of 1981 (ERTA), Congress has already reduced corporate tax incentives to give by, in effect, reducing the number of corporations who have taxable income. As you know, corporations are limited to deductions for giving that are equal to a maximum of 10 percent of corporate taxable income.

It appears that the effect of these recent tax changes for those few corporations that contribute the maximum to charity may be an early breaching of the 10-percent ceiling on deductible corporate gifts. Thus, at a time when a major governmental theme urges private sector involvement in meeting national needs, it seems that the tax incentive to make those gifts may be reduced in attractiveness and made available to an ever smaller number of donors. In addition, it appears that the application of this proposed tax will be uneven in its effect on different classes of corporate donors. The more generous, such as many small, family-owned corporations that give much more than the average corporate gift, would feel the Federal restraints on giving more than their less generous colleagues. I find it hard to believe that this is a result this government wishes to achieve.

In sum then, I would urge the Ways and Means Committee to oppose any tax increases on charitable giving—this sector already gave last year through two rounds of spending cuts and ERTA. Surely there must be other ways to solve the Nation's budgetary crisis than by creating a further financial drain on the vitality of the not-for-profit sector.

Mr. RANGEL. Mr. Anthony.

Mr. ANTHONY. I have no questions.

I would just like to compliment the panel on their excellent presentation and just say, as far as the tax-exempt status for college and universities, you have one solid friend on this committee. I will do everything that I can to help preserve it.

The State of Arkansas has utilized this avenue extremely well and had it not been for this particular avenue, I am not sure that we would even be where we are today in education, and we still have a long way to go in my State.

Unfortunately, only 47 percent of the students that get out of high school go on to higher education and/or vocational technical education in the State of Arkansas. With the budget cuts coming as they are on education, and then to take away probably the last tool that the States, the universities, and colleges have, I think would just be compounding the problem.

If anything, I think the Federal Government from a national policy standpoint, owes more to try to educate our young people than at any time in our history, because if we do not educate our young people, especially for high technical jobs, there is no way we are going to be able to compete with these foreign countries that literally have stripped away some of our competitive edge, and I just want you to know that I will be happy to work with you and assist you any way that I can in that endeavor.

Mr. RANGEL. Let me thank the panel. I think that when we look at the need for university and educational systems, I know that we are talking about the future of America as it relates to the education of our youngsters, and then taking into consideration the power of some of your boards of trustees, it is clear that in the competition of what is going to be funded, for a variety of reasons, you probably will come out ahead.

It would help us a great deal, however, if you would see other issues that need the same type of equitable support and lend your power of persuasion to those types of programs as well. Because, for some of us who deal with the so-called tax incentives or subsidies, we get carried away with the whole thing and try to clean up the system. I do not see how we can do that in view of what we did last year.

But we hope that you might not just narrow your focus on that part of the tax system and try to push something through that is more equitable than what we did last year which can share the popular support that your program has politically, in an election year, in the Congress.

I know the Governor more than anyone else appreciates what I am saying.

Thank you so much.

The Council of Pollution Control Financing Agencies. Jesse Unruh, director, treasurer, State of California, chairman of California Pollution Control Financing Agency will have with him Ron Linton; Walter Rogowski, vice president, National Committee on Small Issue Industrial Development Bonds, counsel of the Marmon Group, Inc; Philip Johnston, counsel to Small Business Coalition for Pollution Control; and Milton Stewart, editor, Inc. magazine, Boston Mass., Small Business Association of New England and Small Business United.

Your full statements will appear in the record. You can proceed as you wish.

STATEMENT OF JESSE M. UNRUH, DIRECTOR, COUNCIL OF POLLUTION CONTROL FINANCING AGENCIES, TREASURER, STATE OF CALIFORNIA AND CHAIRMAN, CALIFORNIA POLLUTION CONTROL FINANCING AGENCY

Mr. UNRUH. Mr. Chairman, members of the committee, I am Jesse Unruh, treasurer of the State of California, chairman of the California Pollution Control Financing Authority, and a director of the Council of Pollution Control Financing Agencies.

As the principal trust officer for the State, I am responsible for the sale of general obligation and revenue bonds for a variety of public purposes. As chairman of the recently created California Debt Advisory Commission, I have an oversight responsibility with respect to all forms of public debt within the State.

I think the underwriting community can assure you that I am about as outspoken as any public official on the proliferation of tax-exempt bonds generally, and that I am a critic of the use of tax-exempt bonds which do not serve a clearly defined public purpose.

I would like to talk about what has been happening in California over the past few years.

I think our experience serves as background for the approach that I would take to these important hearings. In the past 3 years, we have seen a 55-percent increase in the volume of bonds issued. Total new bond indebtedness has exceeded $10 billion.

At the State level, the largest growth has occurred in the issuance of revenue bonds. Starting in the 1979 and 80 fiscal year for the first time, revenue bonds surpassed the amount of general obligation bonds and then only 1 year later, nearly twice as many revenues as GO's were sold.

At the State level, we have 14 agencies authorized to issue revenue bonds. Half of those authorities have no bonding cap whatsoever. One of our newer agencies, one which I unsuccessfully opposed incidentally, is the California Industrial Development Financing Advisory Commission. That commission oversees the sale of up to $2 million in bonds by local industrial development authorities.

Many of our jurisdictions in California are not subject to our oversight and an effort is being made now to raise the cap to $250 million per year in this particular field.

Finally, I would point out that there are 2,130 local governmental units in California with a current general obligation bonded debt of $8.8 billion. There are 257 units with revenue secured debt of $5.8 billion and growing fast. So I think you can readily understand with what enthusiasm I greet your hearings into this matter. It is a matter of grave concern.

I also applaud the administration's attempt to come to grips with the entire matter of industrial development bonds. Quite frankly, I do not think that we should be in the business of financing with tax-exempt bonds such projects as national retail chain stores, motels, golf and tennis facilities, massage parlors, pizza parlors, and the renovation of sports stadiums.

I would draw a distinction, however, between the use of industrial development bonds for these purposes and the use of such bonds to clean up our air and water and to attempt to solve the solid and hazardous waste crises which affict most of our States.

Bona fide pollution control bonds finance the purchase of nonproductive pollution control facilities mandated by the Clean Air Act, the Clean Water Act and the Resource Conservation and Recovery Act. These were not really implemented until the latter part of the 1970's, which accounts for the recent dramatic growth in their use.

Clearly, the public wants and needs these laws and their objectives. The citizens of California amended the constitution a few years ago to make pollution control bonds constitutional and possible.

In these subsequent 10 years, we have sold in excess of 650 million dollars' worth of pollution control bonds. Some of that has been for large corporate concerns, but until recently, however, the larger number of projects financed—not the larger dollar amount but the larger number, were for smaller and medium-sized businesses.

IBM needs us nearly as much as Al's Nickel Plating Shop does, but if we are gong to finance an IBM we have an obligation to continue to finance Al's Nickel Plating Shop.

I am afraid that with the administration's abolition of the small business guaranteed loan program that the various pollution control authorities will find themselves in a position of financing the firms that need us least and being unavailable to help the firms who need us the most.

It would seem the administration is now coming forward with proposals that would effectively abolish pollution control financing altogether. I would submit that it is not fair and I hope nobody throws a rule book at me here that says, show me where it says you have to be fair.

It is not fair and it is particularly not fair to small and medium-sized firms to abruptly mandate steps to clean up their shops on the one hand, and then take away the tools they need for that purpose on the other.

In some cases the investments for mandated pollution control equipment exceeds entire net worth of the company. Clearly, I think that pollution control financing is a legitimate use of tax-exempt bonds. Just as clearly, I think we have an obligation through some form of guarantee program to make that financing available to the small businesses.

As Congress moves forward in this area, I would urge you to make a distinction between pollution control financing for example, and other imaginative forms of industrial development bond financing.

Much of that financing goes, at least in our State, to public utilities which in turn are supposed to, at least, and I think in most cases do, pass those savings on to the rate-paying public.

We have, I think, an obligation to preserve this very valuable tool.

I believe that a proposal you might want to consider is to limit industrial development financing to the urban enterprise zones the President has been talking about lately. Some adjustments for poverty impacted rural areas should be considered, but the President's proposal in my judgment has a great deal of merit.

Alternatively, you may want to examine the possibility of limiting industrial development financing to economically distressed areas.

Or you might want to approach industrial development financing much in the manner you approached single-family mortgage revenue bonds through the Ullman Act. You might want to set a national cap on the total amount of industrial development financing you will permit with specific maximum allocations going to the individual States.

The States in turn would have the responsibility to determine how their respective allocations would be used.

In this way, the Congress could control the total volume of issues with an eye toward revenue savings while, at the same time, establishing public purpose guidelines.

As a matter of fact, if Congress were to take this approach to all revenue bonds, which I suggest would be a much simpler, cleaner way to handle this than the various proposals contained in the administration proposals, it would aid our efforts at the State level to exercise greater responsibility.

Many recent court decisions have held that our California charter cities, which are most of our large cities and medium-sized cities, are totally out of our control insofar as the State limitations on revenue bonding is concerned.

They can issue revenue bonds for almost any purpose they want to. We have little or no authority to act to contain that. A Federal limit on revenue bonds of all kinds with the internal allocation left to the States, would represent a balanced federalism approach and at the same time, would help us plug the leaking holes in our end of the boat.

For example, one of our cities in California recently, in one sitting of their city council, without even names or incorporations, passed $260 million of revenue bond authorizations in about 30 minutes at the urging of a particular bond counsel.

I do believe this is the best, cleanest way. It represents a partnership in solving this problem which I think many States would welcome. I appreciate the opportunity to be here with you.

I will try to respond to any questions you might have.

[The prepared statement follows:]

Statement of Jesse M. Unruh, Treasurer, State of California

Mr. Chairman and members, I am Jesse Unruh, Treasurer of the State of California. I chair the California Pollution Control Financing Authority and serve as a Director of the Council of Pollution Control Financing Agencies.

As the principal trust officer for my state, I am responsible for the sale of General Obligation and Revenue Bonds for a variety of purposes. And as Chairman of the recently created California Debt Advisory Commission, I have an oversight responsibility with respect to all forms of public debt within the state.

The underwriting community itself can assure you that I am extremely sensitive to the proliferation of tax-exempt bonds generally and that I am critical specifically of the use of tax-exempt bonds which do not serve a clearly defined public purpose. I share the belief that the use of tax-exempt bonds for what many of us consider to be inappropriate purposes tends to crowd out of the market bonds for more legitimate public purposes.

If I may, I should like to tell you what has been happening in California over the past few years. Our own experience serves as background for the approach I would take to these important hearings.

In the past three years, we have seen a 55 percent increase in the volume of state and local bonds issued. Total new bonded indebtedness over that three-year period exceeded $10 billion. At the state level, the largest growth has occurred in the issuance of Revenue Bonds. The amount of Revenue Bonds issued surpassed the amount of General Obligation Bonds sold for the first time in the 1979-1980 Fiscal Year. Only a year later, nearly twice as many Revenue as G. O. Bonds were sold.

At the state level, we have 14 agencies authorized to issue Revenue Bonds. One-half of those authorities have no bonding cap. One of our newer agencies—one I unsuccessfully opposed, by the way—is the California Industrial Development Financing Advisory Commission. That Commission oversees the sale of up to $200 million in bonds by Local Industrial Development Authorities. Many jurisdictions are not subject to our oversight and an effort is being made to raise the cap to $250 million per year.

Finally, I would point out that there are 2,130 local government units in California with a current General Obligation Bonded Debt of $8.8 billion. There are 257 units with revenue secured debt of $5.8 billion and growing fast.

So I think you can readily understand, Mr. Chairman and Members, why I would enthusiastically commend the Committee's interest in this subject. I also applaud the Administration's attempt to come to grips with the entire matter of Industrial Development Bonds.

Quite frankly, I don't think we should be in the business of financing with tax-exempt bonds such projects as national retail chain stores, motels, golf and tennis facilities, massage parlors, pizza parlors, and the renovation of sports stadiums.

I would draw a distinction, however, between the use of industrial Development Bonds for those purposes and the use of such bonds to clean up our air and water and to attempt to solve the solid waste and hazardous waste crises which afflict most of our states.

Bona fide Pollution Control Bonds finance the purchase of nonproductive Pollution Control Facilities mandated by the Clean Air Act, The Clean Water Act, and the Resource Conservation and Recovery Act. These enactments were not implemented until the latter part of the seventies which accounts for the recent dramatic growth in their use. Clearly the public needs and wants these laws and their objectives. The citizens of California approved the use of tax-exempt financing for pollution control projects ten years ago through a Constitutional Amendment on our ballot.

In the subsequent 10 years, we have sold in excess of $650 million worth of Pollution Control Bonds. Some of the financing has been for large corporate concerns. Until recently, however, the larger number of projects financed were for smaller and medium sized business.

Now, I don't think IBM needs us as much as Al's Nickel Plating Shop, but it does seem to me that if we are going to finance IBM then we have an obligation to continue to finance Al's Nickel Plating Shop.

I am afraid, however, that with the Administration's abolition of the Small Business Guaranteed Loan Program for Pollution Control, the various pollution control authorities around the country find themselves in a position of financing the firms who need help the least . . . and being unavailable to help the firms who need it the most.

It would seem that the Administration is now coming forward with proposals that would effectively abolish pollution control financing altogether. I would submit that it is not fair . . . and it is particularly not fair to small and medium sized firms to abruptly mandate steps they must take to clean up their shops on the one hand and to take away the tools they need for that purpose on the other.

In some cases, the investment for mandated pollution control equipment exceeds the entire net worth of the company. Clearly, I think that pollution control financing is a legitimate use of tax exempt bonds. Just as clearly, I think we have an obligation through some form of guarantee program to make that financing available to the small and medium sized firms . . . especially if we are going to make it available to the larger firms.

As the Congress moves forward in this area, I would urge you to make a distinction between pollution control financing, for example, and financing for the more esoteric forms of industrial development financing.

Some uses of industrial development bond financing should be prohibited on policy grounds. Other uses should be constrained because of the aggregate impact their unrestrained use has on revenue sources and revenue volumes. With respect to the second objective, there are some ideas I would commend for your consideration.

You might want to explore, for example, the proposal to limit industrial development financing to the urban enterprise zones the President has been talking about lately; some adjustments for poverty-impacted rural areas should be considered, but the President's proposal in my judgment has some merit.

Alternatively, you may want to examine the possibility of limiting industrial development financing to designated "economically distressed" areas which already exist.

Or finally, you might want to approach industrial development financing much in the manner you approached single family mortgage revenue bonds through the Ullman Act. That is to say, you might want to set a national cap on the total amount of industrial development financing you will permit with specific maximum allocations going to the individual states. The states in turn would have the responsibility to determine how their respective allocations would be used. In this way, the Congress could control the total volume of issues with an eye toward revenue savings while at the same time establishing public purpose guidelines.

As a matter of fact, if Congress were to take this approach to all Revenue Bonds, it would aid our efforts at the state level to exercise greater responsibility ourselves. Recent court decisions have held that our charter cities (which is most of our large and medium-sized ones) are for all practical purposes free of state limitations on Revenue Bonding for virtually any purpose they choose. A federal limit on Revenue Bonds of all kinds with internal allocation left to the states would represent a balanced "Federalism" approach and at the same time would help us plug the leaking holes in our end of the boat.

I appreciate the opportunity to be here and I will be pleased to answer any questions you may have.

Mr. RANGEL. Mr. Rogowski, vice president of the National Committee on Small Issue Industrial Development Bonds.

STATEMENT OF WALTER S. ROGOWSKI, VICE PRESIDENT, NATIONAL COMMITTEE ON SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS, AND VICE PRESIDENT AND GENERAL COUNSEL, THE MARMON GROUP, INC., CHICAGO, ILL.

Mr. ROGOWSKI. My name is Walter Rogowski. We have utilized bonding for industrial development in States. Our committee believes it is imperative that industrial bond financing be able to continue in view of the current economy and high interest rates.

There has been much publicity about abuses and criticisms of certain aspects of IDB financing. We believe these have been minor. If the Congress, nevertheless, believes there is merit to limiting such financing, we urge that it not affect use of bonds for financing industrial facilities.

Originally, these were used to finance industrial facilities. This continues to be the primary purpose in many States. During the extensive hearings before the House Ways and Means Oversight Subcommittee in April 1981, no abuses were cited in use of industrial development bonds for industrial purposes.

There was virtually no criticism for their continued uses for industrial purposes. Use of industrial development bonds is necessary to give companies the incentive and impetus to expand and modernize facilities, so that productivity may be increased to meet and beat foreign competition.

The continued allowance of the accelerated cost recovery system is also needed together with industrial development bond financing because we believe that ACRS is the generator of cash flow, the financial assistance to allow us to become profitable sooner after plant startup, and to stay profitable.

In this economy, it is the combination of IDB's and ACRS which allows us to expand. We also believe that industrial development bonds should not be limited to small companies. Nor should there be a cumulative dollar cap in use of IDB financing.

We believe each issue should stand on its own merits because it is that single issue that benefits the community with jobs and commercial growth.

The present individual issue cap of $10 million, which we believe is too low, is certainly sufficient control to keep any one single facility from unduly affecting the community stability. Communities should have the right to choose a mix of industry and not be limited to small companies alone.

Industrial expansion in my company has been greatly facilitated by use of IDB financing. We can show benefits to the Treasury, the local and State Governments through payments of increased taxes. Our company alone has added approximately 4,500 direct jobs as well as numerous jobs in satellite industry and commercial establishments and communities where we are located.

This has been accomplished through use of industrial development bond financing for industrial purposes. Our committee urges the Congress to allow industrial development bond financing to remain.

But if it sees fit to address those few abuses, we ask the baby not be thrown out with the bath water and financing for industrial purposes be permitted to continue.

Thank you.

[The prepared statement follows:]

STATEMENT OF WALTER S. ROGOWSKI, VICE PRESIDENT OF THE NATIONAL COMMITTEE ON SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS, AND VICE PRESIDENT AND GENERAL COUNSEL OF THE MARMON GROUP, INC.

Mr. Chairman and members of the Committee, my name is Walter Rogowski. I am Vice President of the National Committee on Small Issue Industrial Development Bonds. I am also Vice President and General Counsel of The Marmon Group, Inc. of Chicago. I appreciate this opportunity to present the views of the National Committee on small issue industrial development bonds ("small issue IDB's"). The National Committee on Small Issue Industrial Development Bonds is a non-profit membership organization dedicated to preserving and increasing the effectiveness of small issue industrial development bonds as mechanisms for capital formation and job creation. The Committee presently has 92 members, principally manufacturing corporations, but also state economic development organizations, investment bankers and other supporting individuals and groups. 1/

1/ List of members of the National Committee on Small Issue Industrial Development Bonds (Attachment A).

Our Committee has been actively involved in matters affecting small issue IDB's since 1978. Our members have worked closely with state and local economic development authorities to understand their needs and concerns. Several state authorities are supporting members of our Committee. The National Committee has commissioned two studies on small issue IDB's. The first, "The Economic and Federal Revenue Effects of Changes in the Small Issue Industrial Development Bond Provisions" by Dr. Norman B. Ture, now Undersecretary of the Treasury for Tax and Economic Affairs, was published in 1980. The second on "The Federal Revenue Losses from Industrial Development Bonds" by Roger C. Kormendi and Thomas T. Nagle of the University of Chicago, was published in 1981.

The National Committee recognizes that there are different views regarding the impact on the Federal revenue of small issue IDB's, depending on the formula or approach used. The dynamic or feed-back approach, advocated by Dr. Ture in the study he did for the National Committee, concludes that the Federal Treasury gains net revenues from the IDB program. In any event, the dollar figures of revenue loss from small issue IDB's advanced by critics of the program are entirely speculative and small in comparison with the revenue losses from other recently-enacted tax provisions, including the tax leasing provisions and the 10 percent cut in personal income tax rates scheduled for July 1, 1983.

The National Committee's Position

The National Committee recognizes that there has been publicity about and criticism of aspects of the small issue IDB program. The Committee believes, however, that the criticism has been out of all proportion to the incidents of abuse. If the Congress, nevertheless, concludes that abuses in the program and the proliferation of IDB issues warrant changes and restrictions at the Federal level on the issuance of IDB's, we urge the Congress to retain the use of IDB's for industrial purposes.

The original purpose of the IDB program was to use IDB's to finance industrial facilities. It continues to be the primary purpose in many states. Furthermore, at the extensive hearings on small issue industrial revenue bonds before the Oversight Subcommittee of this Committee in April 1981, no abuses were cited in the use of IDB's for industrial purposes, and there was virtually no criticism of the continued use of IDB's for industrial purposes in the Oversight Subcommittee's report and recommendations.

IDB's are now being used to finance industrial facilities in 48 states from Alaska to Florida from Michigan to Mississippi. IDB's have provided access to capital, which made possible the much-needed investment in plant and equipment and created new jobs or retained existing jobs. These industrial jobs are the core jobs, the long-term, permanent jobs that a community needs. The location or retention of an industrial facility in the community creates a ripple effect in the community, attracting other smaller firms, creating service jobs, increasing the local tax revenues and encouraging further economic development.

The National Committee's position is to support the continued use of IDB's for industrial purposes and to recommend that the use of IDB's for commercial purposes be targeted to economically distressed areas. The National Committee has no objection to the use of IDB's for commercial purposes per se but has adopted this position in support of targeting of commercial uses in response to the criticisms of the so-called abuses, the concern about the growing volume of IDB's and the proliferation of non-traditional uses.

The definition of economically distressed areas should be determined by the Congress. There are some definitions presently available. One, based on the pockets of poverty criteria is incorporated in H.R. 4420, introduced by Rep. Rangel, Rep. Gibbons and Rep. Moore on September 9, 1981. Others are the criteria developed by the Urban Development Action Grant Program ("UDAG"), for economic distress for cities and urban counties and for pockets of poverty in non-distressed cities. Other standards based on unemployment and income could be developed, which would give the states some flexibility in designating areas for economic revitalization. Several states, including Massachusetts and New Jersey, have developed such programs for targeting commercial uses.

In addition, the National Committee supports the following positions regarding small issue IDB's:

Legislation should include a provision to eliminate research and experimental expenditures from the definition of capital expenditures for purposes of the small issue exemption. Bills in support of this position were introduced by Rep. Shannon (H.R. 4444 and H.R. 1185) and by Senator Moynihan (S. 768) and by Senator Denton (S. 1472) and language to this effect was adopted by the Senate as an amendment to a miscellaneous revenue bill H.R. 4717 in December 1981, which is now pending conference.

The National Committee supports legislation to require reports from the states to the United States Treasury regarding all state and local IDB's issued during the year as is included in H.R. 4420. The National Committee also supports legislation to require public notice and the opportunity for public comment or protest prior to the approval of the issuance of an IDB. The National Committee regards the specific language that implements these requirements as critically important because it is crucial that the requirements do not overburden and complicate the issuance of IDB's to a point where the programs are paralyzed or eliminated. We have analyzed these two recommended changes in the program with considerable care and have some suggested revisions to the drafted language which meet the concerns of and are acceptable to the IDB community, which we will make available to the staff, if the Committee decides to amend the existing legislation.

Opposition to the Treasury's Proposals

The National Committee strongly opposes the Treasury's proposals that would require assets financed with industrial development bonds issued after 1982 to be depreciated using the straight-line method over an extended recovery period and would eliminate the use of small issue IDBs by large businesses. The National Committee believes there are compelling reasons why such proposals should be rejected. These reasons include inordinately high interest rates, high unemployment, the needs of the communities to have economic development tools, and the need to address the abuses in the IDB program.

A legislative proposal to prevent double dipping, that is, to require a choice between the use of IDB financing and accelerated cost recovery system ("ACRS") is counterproductive to the Administration's goal of economic recovery because:

(1) The needs and benefits are different: IDB financing reduces the initial cost of the financing. It assists in making capital available to industries. It spurs the modernization of plant and equipment now rather than at some future date. It addresses businessmen's concerns regarding the persistent and inordinately high interest rates which have caused this present recession, prevented investment, created unemployment and reduced output. As the *Wall Street Journal* stated, quoting Lee Iacocca on Friday, February 19, "There

is no way for business to do business when the rates are between 15 percent and 20 percent." In spite of the Economic Recovery Tax Act of 1981, business is revising its investment plans downward rather than upward because the steep rise in interest rates has offset the incentives of ACRS. Economist Rudy Penner of the American Enterprise Institute was reported in The Washington Post on Friday, February 19, as saying that "the additional cost of capital because of higher interest rates now outweighs the tax-induced reduction in the cost of buying new plants and equipment."

(2) In addition, the uneven treatment under ACRS of different assets and industries has been documented by the Economic Report of the President (February 1982, pp. 124-125) in that investments in longer-lasting machinery and buildings are treated less favorably. Industries dependent on these investments such as industries producing machinery and instruments, food, services and trade, will continue to have higher effective tax rates and will be treated least favorably.

(3) ACRS affects the cash flow and the rate of cost recovery. It is especially important to business in an inflationary period, but it does not reduce the initial cost of obtaining capital. Furthermore, interest costs, once incurred, unlike some operating costs, do not decrease

during periods of economic slowdown. The high initial cost of obtaining capital is, therefore, the significant impediment to investment in the present economic climate.

(4) Interest rates and the rate of inflation are separate issues. The Administration has made great strides in reducing inflation, but it has been unable to reduce interest rates, and the consequences of persistently high interest rates are apparent in the unemployment figures, in declining output, and in delayed investment. Until interest rates are substantially reduced, IDB financing is one of the few ways business can undertake new investments in plant and equipment.

The Administration's proposal to prevent large businesses from using small issue IDB's is also counterproductive to the Administration's economic goals because:

(1) The states and local governments want to retain the right to decide when and where they may want large and medium-sized businesses to locate in their communities since it is these firms that provide permanent employment, generate increased tax revenues, serve as a magnet for attracting other firms and generally are responsible members of the community. Moreover, the arrival or retention of a large or medium-sized firm is a catalyst for economic recovery because

it creates a ripple effect of additional jobs, services and investment in the community. The state and local governments are facing substantial cuts in federal assistance, decreased tax revenues, increased transfer payments and substantial new responsibilities under the Administration's proposed Federalism. They need IDB's more than ever to provide economic development and to replace the programs and services that are being terminated by the Administration's budget cuts.

(2) No state at present excludes large or medium-sized businesses from its IDB program; on the other hand, many states limit the use of IDB's to industrial, manufacturing and processing uses and exclude or restrict the use of IDB's for commercial purposes.

(3) Large and medium-sized businesses face the same problem of the cost of capital that all businesses face, and they are postponing investment and reducing employment as they are squeezed by interest rates. When considering the construction or expansion of a facility, large companies, just like small ones, must evaluate the costs and potential returns before an investment can be made. In order to be approved, the project must pass the "hurdle rate" for return on investment. At today's interest rates projects of even the largest companies often do not exceed the hurdle rate if

they must be financed by market rates. Eliminating the use of IDB's by large and medium-sized companies will reduce capital investments as projects are delayed or abandoned.

(4) Elimination of large and medium-sized businesses from the IDB program would discriminate against manufacturing and industrial firms. These are the firms that have major capital expenditures and that have been most affected by the present interest rate-caused recession.

(5) Furthermore, the $20 million cap on worldwide capital expenditures that Treasury is proposing would affect high technology firms of all sizes. These firms operate in a highly competitive, rapidly evolving industry in which equipment and products must be updated constantly. Although many of these firms are small, they frequently have worldwide capital expenditures in excess of $20 million in a six-year period, and they have the potential to grow rapidly. The Administration's proposal would discriminate against the most productive uses of IDB's for high technology and manufacturing exports in which the United States remains, for the time being, the world leader. The United States position, however, is being eroded in these fields as it has been in such industries as automobiles, steel, cameras, televisions and radios. The present $10 million limit on the bonds issued and on the capital expenditures within a six-year period already imposes severe restrictions

on the size of facilities financed with IDB's. If the 1968 limits had kept pace with inflation, the $5 million limit enacted in 1968 and the $10 million enacted in 1978 would be $15 million in mid-1982.

(6) The Treasury's proposal that corporations be limited to $10 million in outstanding small issue IDB's at any time would also eliminate corporations of all sizes, if a firm had financed one or two facilities with small issue IDB's. It would also remove from the states and local governments the authority to choose what investment and economic development mix they want.

(7) Unemployment is severe in certain industries and areas which have used IDB's successfully for the creation and retention of jobs. In the current recession, blue collar workers in the goods-producing sector have borne the brunt of the unemployment rate, which increased to 12.9 percent for them in January. The effectiveness of IDB financing in creating jobs has been demonstrated by the following information provided to us by the States. For example, Louisiana estimates that it has created or anticipates the creation of 9,667 permanent jobs and 15,999 temporary jobs in connection with IDB projects financed with IDB's from 1979 to 1981. In three years, Massachusetts has created 47,000 new permanent jobs through the use of IDB financing. Texas in 1981 approved 242 IDB issues which are estimated to create 18,172 jobs. Minnesota reports that 23,000 jobs were or will be created

by IDB's approved in 1981. Rhode Island estimates that IDB facilities created 1,781 jobs in 1981. New Jersey reports that 65,000 persons are currently employed in permanent jobs that have been created by IDB financed facilities since 1974. For 1981, New Jersey estimates that 13,336 new permanent jobs and 11,182 construction jobs will be created from the IDB financed facilities. St. Louis County Industrial Development Authority has issued 98 bonds since its inception in 1979 for facilities which have created or will create 4,800 jobs in St. Louis County. Mississippi, the first state to use the program, has continued to use it almost entirely for industrial purposes. Like the other states, Mississippi has no prohibitions regarding the size of the company which may use IDB financing. Over a forty-year span, Mississippi has used IDB financing to build plants for at least 55 corporations among the Fortune 500 industrial corporations and credits its IDB program as vital in its development of industrial facilities and industrial jobs in the State.

(8) Elimination of large and medium-sized businesses from using IDB's would not eliminate the so-called abuses from the program. It would probably leave the majority of those activities, cited as abuses in published reports and Congressional hearings, intact while hurting community economic development efforts and the creation of core jobs.

Favorable interest rates for borrowing to finance new plant and equipment are essential if United States firms are to compete in the domestic and international markets.

(1) The Japanese use preferential interest-rate financing. In fact, they use interest-free loans to encourage certain export-related priority industries, in conjunction with a rapid depreciation schedule to encourage investment. Loans made for technology projects by the Ministry of International Trade and Industry (MITI) bear no interest. Loans made by the Japanese Development Bank (JDB) bear a preferential interest rate. Furthermore, the discount rate of the Central Bank of Japan is now only 5.5 percent. Savings are encouraged by making the annual interest on the first $3 million yen deposited in the Postal Savings System tax-free for each depositor. In addition, the annual interest rate on these savings is 6.25 percent, which is the same rate as interest earned on time deposits at commercial banks.

(2) Because of these favorable interest rates, American firms which have to borrow money at 15 percent to 20 percent, cannot produce a competitively priced product. As a result American firms are increasingly losing out in both the

international and the domestic markets to Japanese firms and to other foreign firms which can obtain capital at a lower cost.

CONCLUSION

Any proposal to prevent large and medium-sized businesses from using small issue IDB financing, either by a worldwide capital expenditure cap, or a cap on the dollar volume of all outstanding small issue IDB's for the use of any one company, or a proposal to require a choice between IDB financing or ACRS will have a damaging economic impact on the communities that seek to attract industry, on the jobs created or retained by IDB financing, and on the competitive position of United States firms against Japanese and other foreign firms. Moreover, the damaging economic impact will far outweigh any estimated revenue gains from the elimination of the use of IDB's by large and medium-sized businesses.

The economy is going through a period of great stress and strain, largely attributable to inordinately high interest rates. Competition from foreign manufacturers is eroding the position of United States industry in both international and domestic markets in an ever-increasing number of product lines. In addition, the Administration is cutting back on many programs and services provided to states, cities and local communities. The National

Committee is convinced that this is the wrong time to be curtailing the small-issue IDB program especially for industrial uses, because the IDB program has proved to be a valuable and important financing tool for states, cities and local communities. Moreover, the National Committee is convinced that concern over small issue IDB's has been blown out of all proportion to the incidents of abuse and the estimated revenue loss from small issue IDB's. If, however, there is to be modification of the program because of the criticism of the abuses, then the National Committee urges that the Congress retain the use of IDB's for industrial purposes and not impose any restrictions on the size of the company eligible to use this financing.

ATTACHMENT A

National Committee on Small Issue Industrial Development Bonds

March 1, 1982

MEMBERS

ABS Industries, Inc.
Ajax Magnethermic Corporation
Akron Foundry
American Greetings Corporation
Anheuser-Busch, Inc.
Baldor Electric Company
Ball Corporation
George K. Baum & Co.
A. G. Becker Inc.
The Binswanger Co.
William Blair & Company
Boettcher & Company
Buffalo China, Inc.
Campbell Taggart, Inc.
Cargill Inc.
Carlisle Corp.
Chromalloy American Corp.
The Continental Group, Inc.
Copeland Corp.
Copperweld Corp.
Corning Glass Works
Dain Bosworth Corp.
The Dyson-Kissner-Moran Corporation
E. F. Hutton & Company Inc.
Eagle-Picher Industries, Inc.
A. G. Edwards & Sons, Inc.
Emerson Electric Co.
Essex Company
First Birmingham Securities Corp.
The First Boston Corporation
First Southwest Company
Franklin Electric Co.
Gantz Investment Company
Goldman, Sachs & Co.
Guild Craftsmen, Inc.
Hart Corporation
Hayes, Inc.
Health Care Fund
Hoover Universal, Inc.
The Hospital Corporation of America
J.C. Bradford & Co.
Joy Manufacturing Company
The Kroger Company
Langenthal Mills

The Marmon Group, Inc.
McDonald and Company
Mine Safety Appliances Co.
The Mortgage Corporation of America
Omark Industries
Plymouth Tube Co.
Portec, Inc.
Powell & Satterfield, Inc.
PPG Industries, Inc.
Ralston Purina Company
Renfrow Foundry
Robinson Foundry, Inc.
The Robinson-Humphrey Co.
South Haven Rubber Co.
Southwire Company
Stephens Inc.
Stifel, Nicolaus & Company Incorporated
Stihl Incorporated
The Synthetics Group
T. J. Raney & Sons, Inc.
UNIPAR Inc.
Vermont American Corp.
Wagner Division - McGraw-Edison Co.
Wetterau Inc.
Wheat, First Securities, Inc.
White Consolidated Industries, Inc.

SUPPORTING ORGANIZATIONS AND INDIVIDUALS

Alaska Industrial Development Authority
Allegheny County Industrial Development Authority
Ballard, Spahr, Andrews & Ingersoll
Chapman & Cutler
Friday, Herschel H.
Gambrell, Russell and Forbes
Georgia Industrial Developers Association, Inc.
Hawkins, Delafield & Wood
Commonwealth of Kentucky, Development Finance Authority
State of Illinois, Department of Commerce & Community Affairs
State of Indiana, Department of Commerce
State of Maryland, Department of Economic and Community Development
North Carolina Industrial Developers Association
North, Haskell, Slaughter, Young & Lewis
Ohio Economic Development Council
Pennsylvania Association of Industrial Development Authorities
Southern Industrial Development Council
St. Louis County Industrial Development Authority
Tennessee Industrial Development Council
Commonwealth of Virginia, Division of Industrial Development
Watkins, Ludlam & Stennis
Wright, Lindsey & Jennings

Mr. RANGEL. Mr. Johnston, Small Business Coalition for Pollution Control.

STATEMENT OF PHILIP C. JOHNSTON, COUNSEL, SMALL BUSINESS COALITION FOR POLLUTION CONTROL

Mr. JOHNSTON. I am here on behalf of the Small Business Coalition for Pollution Control. We represent approximately 110 small businesses that have applied for guarantees under Small Business Administration pollution control facilities financing guarantee program. We believe that there are many small businesses that have or will have need to resort to this program within the next few years in order to comply with pollution control requirements applicable to them. The Office of Management and Budget and the Treasury have reduced the annual funding level of this program from $250 to $150 million, and more importantly, have decreed that guarantees may only be issued for taxable, rather than tax-exempt bonds. This action has stopped the program in its tracks. To my knowledge, no company has proceeded to closing of an issue of taxable bonds.

In the course of these hearings, you have heard some sizable numbers discussed, that is billions of dollars. This program is, in relative terms, tiny. According to the Public Securities Association, the amount of pollution control IDB's issued in January 1982 alone would approximate the $250 million amount originally authorized for an annual level of guarantees under this program. Access to this program is a matter of survival to many of the small businesses we represent. This program and its intended beneficiaries are caught in the middle of the overall debate over the future of IDB financing. Ironically, although the administration proposes to change the law effective December 31, 1982, its administrative actions toward this program have crippled its operations since the summer of 1981.

I will briefly mention several problems with the notion that the SBA guarantees should be applicable to taxable bonds. First, interest rates are too high. Indeed, it will be a strain for many of these businesses to pay interest at prevailing tax-exempt rates. As Mr. Unruh mentioned, sometimes the requirements for pollution control financing exceed the net worth of the company involved. The second problem is that there is no established market for taxable bonds of this kind. According to investment bankers we have talked to, the market, if there is one to be found, may be indeed pension funds and pension funds don't pay Federal income tax. Therefore, it appears to us that there will be no direct gain to the Treasury from the issuance of taxable bonds under this program. Third, many State and local governments face legal constraints upon their ability to issue taxable bonds and, in any event, are reluctant to do so because the result, ultimately, will be to confuse the investment community about whether a particular investor holds a taxable or tax-exempt security.

The administration argues that the SBA guarantee program represents a subsidy for polluters. It encourages investment in such industries. This assertion of "economic Darwinism" has the appeal of all highly theoretical arguments. The problem is that it does not comport with reality. First, the small businesses governed by pollution control laws run the gamut of agricultural and industrial activities. These include, for example, agricultural cooperatives, appliance manufacturers, metal fabricators, dry cleaners, food processors, chemical manufacturers and formulators, paint and coating manufacturers, printers, paving contractors, and small foundries. All of these produce products essential to our economy. Many of these are family- and employee-owned businesses which do not enjoy a great deal of pricing flexibility. They are not the apple of venture capitalists' eyes.

In this regard, I recall a conversation I had with the son of a small businessman who sold out to other owners and retired. I asked the son if he would plan to start a similar business of his own if things didn't work out with the new owners. His reply was that the anticipated rate of return would not justify new investment to start such a business. "It is a business you inherit, but do not go into by choice," he said. The SBA guarantee program merely offers some assistance to small businesses, many in similar circumstances, who desire to continue rather than close their doors.

Second, the administration's argument ignores the fact of pollution control regulation. Higher standards are being imposed on businesses than was the case during the seventies. For example, the Water Pollution Control Act of 1972 imposes a second and higher stage of requirements which goes into effect in 1983. In addition, we would point out the same business in one locality doing the same thing may be required to spend substantial sums for pollution control equipment while its counterpart in another locality may continue to operate without such equipment. The situation arises from, for example, ambient air quality standards which differ from location to location, depending upon the aggregate of pollutant discharges in a particular area.

Third, the administration's argument apparently overlooks the fact that this Congress and the Federal Government have long since departed from a laissez-faire approach to our economy. There are, of course, innumerable examples of attempts to respond to the particular needs and situations of farmers, laborers and businessmen, who may be temporarily or permanently disadvantaged in our economy.

While I have talked about the particular plight of the SBA program, I would add that we are very concerned about the IDB legislation generally. The IDB program is highly regulated by the Internal Revenue Service and by the private sector through investment bankers, bond purchasers, and bond counsel. It is not an area where chances are taken. Thus, any change in the law must be carefully drafted, so that it does not restrict access to IDB financing beyond what is intended. Many small businesses utilize the $1 million or $10 million exemptions under current law, whether they are financing pollution control, equipment, or other new facilities or a mixture of both. We are highly critical of elements of the administration's proposal such as the local contribution—we don't think we could compete very effectively for whatever might be available—and targeting—we have no assurance that the target areas would at all coincide with areas where pollution control expenditures are essential. We ask your assistance in freeing the SBA guarantee program from its shackles and that any change in IDB legislation preserve such financing as a viable option to small business, particularly in this time of high interest rates.

[The prepared statement follows:]

STATEMENT OF PHILIP C. JOHNSTON, COUNSEL TO THE SMALL BUSINESS COALITION FOR POLLUTION CONTROL

SUMMARY

The Small Business Administration's (SBA) pollution control facilities and equipment financing program was authorized by the Small Business Investment Act of 1976 in order to allow small businesses to obtain access to the tax-exempt bond markets for the financing of facilities and equipment required to comply with Federal, State and local environmental regulations.

In establishing this program, Congress recognized (1) that small business needed to be assured of the access to financial markets enjoyed by larger businesses and (2) that obtaining ordinary debt financing without the Federal guarantee was nearly impossible because of the disproportionate cost of the equipment in relation to most small businesses' net worth and profitability and the dubious collateral value of the equipment. It is a program of "last resort" for these businesses.

This program has assisted over 200 small businesses through the guaranteeing of nearly $300 million in tax-exempt bonds, averaging $1.5 million each. Nearly $130 million in additional applications are presently pending.

The Administration has prohibited the further use of SBA's authority for guaranteeing tax-exempt bonds through this program. It did this by a proviso attached to OMB's apportionment and reapportionment schedule for SBA for FY82. Treasury concurred in this prohibition. The action was contrary to the statutes, their legislative histories and the prior administration of the program. Further, it was taken without consultation with Congress or its tax-writing committees.

The Administration's principal objectives are (1) to reduce the program's contribution to the crowding out of available capital and (2) to reduce potential tax revenue losses to the Treasury. Both objectives fail. As to the first, $150 million or $250 million in tax-exempt bonds is a tiny part of the multi-billion dollar amount of tax-exempt bond volume. As to the second, to the extent Federally-guaranteed taxable bonds can be marketed, they will be sold to qualified pension plans, which are exempt from current taxation, and to the extent they cannot be sold, tax revenue losses from reduced corporate and personal income taxes resulting from a closing of these small businesses will exceed tax revenue gains.

Under present law, the small business required to install pollution control equipment has two alternatives in pursuing tax-exempt financing. First, it can seek to qualify its facilities under IRC §103(b)(4) as an "exempt facility," a difficult engineering, accounting and legal task. Second, it can pursue a small issue exemption under IRC §103(b)(6) within the $1 million or $10 million limitations. Thus, if the OMB proviso is rescinded and the SBA program retained, the elimination or constriction of the small issue exemption would severely hamper the ability of small business to finance such facilities.

STATEMENT

THE OFFICE OF MANAGEMENT AND BUDGET'S AND TREASURY'S ATTACKS ON THE SBA'S POLLUTION CONTROL FACILITIES FINANCING GUARANTEE PROGRAM: A CASE STUDY IN COUNTERPRODUCTIVE CONSEQUENCES

Mr. Chairman and Members of the Committee:

My testimony today is offered on behalf of The Small Business Coalition for Pollution Control. It is directed at the Office of Management and Budget's (OMB) and Department of the Treasury's attacks on the Small Business Administration's (SBA) pollution control facilities industrial revenue bond financing guarantee program.

This particular part of the broader IDB issue before you is of importance for two reasons. First, OMB's and Treasury's attacks on this particular program are part of their coordinated attacks on IDBs in general. Second, this Committee's and this Congress's resolution of the broader issues will affect the survival of this particular program.

We desire this Committee and Congress to recognize that the Administration is threatening to destroy this important program. We believe this threat is made without an adequate understanding by Administration policy makers of the real consequences of their proposals and of Administrative actions directed toward the program.

These real consequences include the undermining of other policy objectives of the Administration: jobs creation, increased productivity, environmental protection and tax revenue generation. As set forth in recent letter to Chairman Bedell of the Subcomittee on Energy, Environment and Safety Issues Affecting Small Business from Ohio Governor James A. Rhodes, jobs are an important consequence of this program, some nearly 8,000 jobs in Ohio alone. I ask that this letter be made a part of this testimony at its conclusion.

The Small Business Coalition for Pollution Control

I am Philip C. Johnston, Counsel to The Small Business Coalition for Pollution Control. I serve in that capacity as a partner in Vorys, Sater, Seymour & Pease, a Columbus, Ohio law firm. The firm is counsel to the Coalition principally through John W. Hoberg as to environmental compliance, Randal C. Teague as to legislative affairs and me. The Coalition was organized last year to heighten the awareness of Congress, the Administration and the public of the issues involved in determining the future of the SBA's pollution control facilities and equipment financing guarantee program.

The Coalition represents those small businesses which have, on the one hand, been required to install pollution control facilities and/or equipment in order to meet pollution control objectives of the Government and which, on the other hand, would face either (1) noncompliance with the statutes, regulations, plans and orders reflecting those policies, or (2) a sale to a bigger business with more assets and borrowing leverage, or (3) insolvency and reorganization, if forced to over-leverage, or (4) going out of business.

The president of the Coalition is Jack L. Schaefer, president of The Specialty Papers Company, a small business printing company in Dayton, Ohio. The company is an SBA loan guarantee applicant.

On behalf of the Coalition, I would propose to discuss briefly: (1) the history of the program, (2) the need for its survival, (3) the Administration's actions toward the program, (4) the Administration's most recent statements concerning the program, and (5) a response to those statements.

History of the SBA Pollution Control Facilities Program

The Small Business Administration's pollution control facilities financing program is really a pollution control facilities and equipment financing program. It was authorized by sections 102-103 of the Small Business Investment Act of 1976 (P.L. 94-305, 90 Stat. 663, 15 U.S.C. 692, 13 C.F.R. 111) in order to allow small businesses to obtain access to the tax-exempt bond markets for the financing of plant changes and equipment mandated by pollution control regulation (air and water pollution control and solid waste management).

That Act authorized SBA to guarantee up to one hundred percent of the payments due from eligible small businesses under qualified contracts for the planning, design, financing or installation of pollution control facilities and/or equipment.

The current limit on a loan guarantee is $5,000,000 principal plus interest, and the average is $1,200,000. The maximum term of the loan is 30 years; the average is 20 years. The applicant must demonstrate the need to overcome financing disadvantage in order to qualify. The applicant pays a guarantee fee of 3.5-percent times principal plus interest, less an escrow deposit of 3 monthly payments. In the event of default, payment is made from the escrow fund first, then from the fund created by the guarantee fees collected and the interest earned thereon. The $15 million revolving fund established by Congress at the beginning of the program has grown through the addition of these fees to over $30 million. It is our understanding that the few defaults experienced are being, or probably will be, recovered by SBA through subsequent agreements with the defaulting small businesses.

The Need

Why is this Federal Government guaranteed and tax-exempt financing necessary? Principally for two reasons:

1. Extensive facility and equipment expenditures are necessary to control air and water and pollution and manage solid waste disposal in order to comply with Federal, State and local environmental policy objectives; and

2. Obtaining ordinary debt financing without the guarantees and tax exemption is nearly impossible because of (a) the disproportionate cost of the equipment in relation to most small businesses' net worth and profitability and (b) the equipment itself generally has little collateral value.

This need has been reflected by the growth in applications received and loan principal guaranteed. This growth did not diminish during the past year's disruption of the program. In a capsule, the growth and the need that growth reflects has been as follows:.

Year	Companies Assisted	Principal	Aver. Prin./Co.
FY77	12	$ 5.7 million	$ 475,000
FY78	14	9.9 million	707,143
FY79	45	41.5 million	922,222
FY80	77	98.5 million	1,279,220
FY81	66	99.9 million	1,513,636

It must be stressed here that the number of applicants measured against the limited available authority assures that this program is indeed one of "last resort." SBA has $129 million of pollution control applications which have been received by it during the past 18 months. There are $35.6 million in commitments outstanding and $93.4 million awaiting processsing.

Administration Actions Toward The SBA Pollution Control Facilities Financing Guarantee Program

In brief, the OMB and Treasury have taken the following administrative actions toward the program:

1. Placed the annual authority ceiling at $150 million in FY82 and FY83 rather than the $250 million ceiling contemplated by existing legislation,

2. Provided that all FY83 authority be available only for taxable rather than tax-exempt bond issues, and

3. Limited SBA's ability to provide staffing for administration of the program.

These actions have essentially prevented small business from utilizing this approach to the financing of pollution control facilities and equipment.

The Administration's Position and the Coalition's Response

The Administration's most recent statements with respect to the SBA program and IDBs generally are contained in Assistant Secretary of the Treasury for Tax Policy John E. Chapoton's statement on March 31 to the Subcommittee on Energy, Environment and Safety of the House Committee on Small Business. I ask that Mr. Chapoton's statement be appended to this testimony.

In general, the Chapoton statement repeats the Administration's major criticisms of IDBs - that they "crowd out" of the market other tax-exempt issues for governmental purposes and that they create a substantial revenue loss to the

Treasury. It also adds some new twists to these arguments. I propose to highlight portions of the statement and offer responses thereto.

"The volume of tax exempt pollution control obligations issued for private businesses was $3.8 billion in 1981, representing approximately 7 percent of the entire long term tax exempt market, and will be an estimated $4.2 billion in 1982."

Even at the $250 million level originally authorized, the SBA program is a tiny part of the total issuances of tax-exempt pollution control obligations. Some of the SBA guaranteed bonds are no doubt categorized as small-issue IDBs rather than pollution control bonds. When measured against the entire market for pollution control and other IDBs, the amount represented by SBA guaranteed bonds appears even more miniscule. This program is vital to the companies which seek to use it. Its "crowding out" effect is insignificant.

"The proliferation of tax exempt bonds has made them less cost-effective as subsidy mechanisms for private activities."

This statement translates to "interest rates are high." They have been for a prolonged period. The Administration does appear to recognize that demand for tax-exempt obligations is now reduced (while continuing to predict an increase in volume in 1982). In fact, the Public Securities Association reports that IDB volume was down 57% to $93 million when compared to January 1981 issuances. To the Coalition these factors indicate (1) that the tax-exempt bond market is correcting itself - clarification of the legislative status of IDBs will remove an artificial stimulus to IDB volume which has existed since early 1981; and (2) it is more difficult than ever for small businesses to obtain affordable pollution control financing - thus the survival of the SBA program is more important than ever to these businesses.

"...in our view the cost of controlling pollution should be regarded as part of the cost of producing goods and should be reflected in market prices."

Small businesses eligible for the program under discussion almost never have sufficient market share to enjoy price elasticity. Thus, the costs to a small business for controlling pollution often cannot be passed on to the consumer unless all businesses in the relevant market are required to achieve the same level of pollution reduction. That is seldom, if ever, the case either because of varying requirements or foreign competition. The fact is that those small businesses able to finance compliance with pollution laws will have to absorb those costs, which in turn will render them poorer credit risks in the first place. Thus the circle completes itself by causing those businesses to be less able to obtain conventional financing, or generate additional revenues from sales, which jeopardizes the small businesses' existence. The true cost of killing this program will be passed onto the taxpayer through lost jobs and lost tax revenue, together with higher prices for those products manufactured by surviving large businesses or imported from nations which do not impose the same pollution requirements.

"...providing tax exempt financing for investments in pollution control facilities ...results in a higher level of investment in polluting industries and a lower investment in other economic activities."

The naivete' of that statement is startling. The statement somehow assumes that polluting activities are restricted to a few businesses and are evidence of inherently evil activities. Nonsense! Virtually every human activity, including paperwork, generates waste which constitutes pollution if it is not adequately handled. Small businesses governed by pollution control laws run the gamut of agricultural and industrial activities. The business of the Coalition's president is being required to control solvents evaporating from inks used on printing presses. Hundreds of small Ohio electroplaters are being required to control discharges of acids, caustics and heavy metals resulting from activities ranging from creating printed electronic circuits to preventing corrosion on small parts found in innumerable types of machinery and vehicles. Small foundries, agricultural cooperatives, appliance manufacturers and metal fabricators, dry cleaning shops, food processors, chemical manufacturers and formulators, paint and coating manufacturers, paving contractors, and virtually every other product-oriented business within our economy can and does generate pollution which must be controlled. The Administration's position against "polluting industries" would seem to allow for few "clean" and approvable pursuits.

> "...most pollution control bonds are issued to finance pollution control facilities for new plants rather than existing plants. Thus, the 'transition rule' argument for tax exemption is no longer applicable in the majority of cases."

We don't have the statistics available to the government, but we believe that statement is patently untrue, at least as it affects small business. There are extensive new pollution control requirements which have not yet been met by existing small businesses throughout the nation. In our cities, wastewater pretreatment requirements and volatile organic compound emission requirements are only now taking effect. The next round of tighter permit requirements under the National Pollution Discharge Elimination System are about to be issued. And the pollution control facilities of the 1970's have often created, because of collection and concentration, a new pollutant of the 1980's - hazardous waste. In many instances businesses previously in compliance with air pollution laws will now also have to control sources of fugitive emissions because ambient air quality standards have still not been met. The compliance problems facing *existing* small businesses because of current pollution control requirements are still formidable. The argument that the problem of financing pollution control facilities is now confined largely to new plants seems to us to be made up out of whole cloth.

"Placing the credit of the United States behind an obligation that is exempt from Federal taxation creates a security which is superior in the market to the direct obligations issued by the Federal government. A Federally guaranteed tax exempt obligation also has a distinct competitive advantage over all other tax exempt obligations issued by State and local governments."

Once again, the SBA program is very small. The Government competes with these bonds through its indirect obligations, especially those of government corporations, e.g., the Tennessee Valley Authority or the Bonneville Power Administration, whose obligations are guaranteed and the income from which is tax-exempt. Does anyone suspect that anything other than the faith and credit of the United States stands ultimately behind TVA, Bonneville and similar bonds? These obligations are a much larger factor in the bond market than the SBA guaranteed bonds.

"...the Public Debt Act of 1941 prohibits the Federal government from issuing tax exempt obligations directly..."

We find it disturbing that the spirit of a 1941 Act is given precedence over the letter of the subsequent Small Business Investment Act of 1976 (Public Law 94-305) and over the legislative history of the Joint Resolution making further continuing appropriations for the fiscal year 1982 (Public Law 97-92). Apparently, Treasury ignores the relevant canons of legislative construction to which its policy would be held in a court of law, to wit: (1) That the letter of the law takes precedence over its spirit and (2) that, when there is conflict between legislative enactments (or legislative intents), the most recent in time takes precedence.

One has a feeling that the Public Debt Act of 1941 was found after the fact in order to justify the OMB decision. It was not an impediment, with the Department of the Treasury or anywhere else, to the first five years of this program.

The legislative history of the 1941 Act is clear that the guiding principle behind the enactment of the prohibition on tax exemption of these 1941 Act obligations was the realization that these obligations produced no tax revenues to offset the tax losses which would occur from tax exemption. That is, these U.S. Government obligations had no offsetting tax revenue gains. The SBA guaranteed bonds, on the other hand, do have offsetting tax revenue gains. They are in the form of Federal corporate taxes paid by the small businesses and Federal individual income taxes paid by their officers and employees, some 250 businesses and 20,000 employees in the history of the program to date. Each time a small business obtains tax-exempt financing and remains in business thereby, revenues are increased in the best case circumstances and maintained in the worst case circumstances. Conversely, the absence of the SBA program would create a high risk of tax revenue losses arising from those businesses closing down and laying off their employees.

There is an arrogance in a way in the assertions made by Treasury which cannot go unmentioned. It must arise from believing that because one has thought of impediments to existing policies that it is the first time anyone has thought of them. These "impediments" have been thought through and by Congress; they have also been rejected. They were fully considered by

Congress in its 1975 and 1976 consideration of the legislation which led to the enactment of this SBA program, and those arguments were rejected in the constitutional processes of the formulation of this law, which processes this Administration has sworn to uphold and defend. I draw your attention to the text of the House (then Select) Committee on Small Business' 1975 hearings, "SBA Assistance for Agricultural Concerns and to Meet Pollution Control Problems," and the subsequent reports (H. Rpts. 94-519 and 94-115) as support for these observations.

The Ultimate Administration Fallacy: The New, Taxable Bonds Will Still Be "Tax-Exempt"

The taxable bonds which OMB and Treasury would have guaranteed by a modified pollution control facilities financing program will still escape current Federal taxation because they will be purchased, if at all, by pension funds.

There is within our economy no existing market for Federally-guaranteed taxable pollution control bonds. There is no market because such an obligation has not yet existed. In order for such Federally-guaranteed taxable bonds to be marketed, a market will have to be created for them. That can be done. It is a matter of determining the characteristics of these bonds and then the most likely purchasers of them.

The Coalition has surveyed the investment banking community associated with the program as it existed prior to OMB's and Treasury's attacks upon it. There are several possible markets, but there is agreement that the most probable market for Federally-guaranteed taxable bonds is pension funds. It is that reality which defeats OMB's and Treasury's intentions in prohibiting SBA from guaranteeing tax-exempt bonds, for pension funds are exempt from Federal income taxation. Thus, they will be paid a higher rate of interest by the small businesses, but they will not have to pay taxes currently on that higher rate.

Adverse Effects of the Administration's Proposed IDB Legislation

Under present law, the small business required to install pollution control equipment has two alternatives in pursuing tax-exempt financing. First, it can seek to qualify its facilities under Section 103(b)(4) of the Internal Revenue Code as an "exempt facility." Under existing Treasury Regulations, however, this approach requires an analysis of financiable costs which is one of the most complex engineering and legal tasks with which I am familiar. This process typically adds thousands of dollars to the cost of issuance of bonds to finance pollution control facilities. The second alternative available to small businesses is the small issue IDB exemption under Section 103(b)(6) of the Internal Revenue Code. These issues can be qualified for tax-exempt financing within the $1 million or $10 million limitations without resort to the difficult and detailed tax analysis to which larger pollution control issues are subjected. The fact that qualifying "exempt facilities" financing is unlimited as to dollar amount is, as a practical matter, irrelevant to small business. In most cases, such businesses lack borrowing capacity in excess of the $1 million to $10 million range. Thus, even if exempt facilities financing is retained, the elimination or constriction of the small issue exemption would severely hamper the ability of small business to finance pollution control facilities.

Certain of the Administration's proposals to make changes in IDB legislation would effectively put an end to the ability of small business to obtain affordable financing for pollution control facilities. For example, the requirement that the local government make a contribution or financial commitment to the financed facility creates an obvious problem. Even if state law were to permit such contribution, I doubt that many local communities would allocate limited resources toward the financing of pollution control facilities for small business as opposed to competing for location in the community of new facilities, particularly those of substantial size perceived to offer greater potential benefits to the community.

The SBA guaranteed loan program for tax-exempt financing of pollution control facilities is a matter of survival for many small businesses. It is essential to participants in the program and insignificant in the Treasury. It should be permitted to continue within the framework and intent of the existing legislation.

Summary

The Coalition believes that Congress should direct Treasury and all other entities involved in the administration of tax policy, e.g., OMB, to carry out the intent of existing legislation with respect to the SBA Pollution Control Facilities Financing Guarantee Program. The program is vital for the small businesses which can participate. We believe it preserves and may enhance the collection of tax revenues.

The case for this position is clear. The merits of this program are:

- The program actually makes money for the U.S. Government.
- The program does not make a measurable impact on the operation of the capital markets.
- The program does permit access by small business to those capital markets.
- The program constituted less than 1% of the small IDB issues in FY81 and will be less than 1% in FY82.
- The program has demonstrable public benefits, particularly the abatement and control of pollution.
- The program has one of the smallest administrative staffs on record.
- The program is funded with private sector funds, guaranteed by the Federal Government.

We urge your favorable consideration of the recommendations set forth herein.

STATE OF OHIO
OFFICE OF THE GOVERNOR
COLUMBUS 43215

JAMES A. RHODES
GOVERNOR

March 9, 1982

Rep. Berkley Bedell
Chairman
House Subcommittee on Energy, Environment,
and Safety Issues Affecting Small Business
United States House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

On behalf of the people of Ohio, I call upon your subcommittee and the Congress as a whole to take whatever steps are necessary to reinstate a small but vital federal loan guarantee program that is being destroyed by an arbitrary decision of the Office of Management and Budget.

That program is the one by which the Small Business Administration has guaranteed tax-exempt financing for pollution control facilities. OMB has, by pure executive fiat, ordered that SBA not guarantee any pollution financing except on taxable issues.

The SBA program has been extraordinarily effective in helping small businesses throughout the country to meet federally mandated pollution control at no cost to the federal government. The program has usually entailed the sale of SBA guaranteed bonds which are free from federal income taxation. In Ohio, nineteen companies, employing 1,498 people, have had their pollution control bond issues guaranteed in the total amount of $36,470,000. We believe that many of these businesses would not have been able to finance their compliance with pollution laws in the normal financial markets. The impact on those companies - and employees - from violating those laws could have been tragic.

But that was just the beginning. Twenty-six more Ohio companies, employing 2,127 people, already have been issued inducement resolutions to finance an additional $46,060,000 of pollution control. OMB's policy shift has put their projects in a deep freeze and their futures in jeopardy. And we know of at least sixty to eighty more small businesses in Ohio, employing from 3,000 to 4,000 people, who are in varying stages of the SBA application process. Without SBA guaranteed tax-free financing, these companies, and many others who don't know yet that they have pollution compliance problems, won't be able to finance mandated compliance.

Ohio will find itself in the unpalatable position of having to enforce federal pollution laws against Ohio businesses who are violating those laws because of federal policy changes which destroyed their ability to comply. That is bad government!

We hope that you will be able to convince the few individuals in the administration who have decreed this arbitrary change to reverse themselves. But if that does not occur, we ask that you promptly develop legislation to require that the SBA continue to guarantee tax-free pollution control financing at the levels previously recommended by Congress.

Yours very truly,

James A. Rhodes

JAMES A. RHODES
Governor

JAR/mls

For Release Upon Delivery
Expected at 9:00 a.m. EST
March 31, 1982

STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ENERGY, ENVIRONMENT AND SAFETY
OF THE
HOUSE SMALL BUSINESS COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am here today to discuss the views of the Treasury Department on guarantees by the Small Business Administration (SBA) of tax exempt industrial development bonds issued to finance pollution control facilities.

The Treasury Department opposes SBA guarantees of tax exempt pollution control obligations. In addition, the Administration is now proposing that Congress enact additional restrictions on all types of private purpose tax exempt bonds. Before commenting upon our particular concerns with respect to pollution control obligations and the SBA program, I would like to review some of the factors that have caused us to conclude that additional limits are needed on all types of private purpose tax exempt bonds.

There has been a virtual explosion in the last five or six years in the issuance of private purpose tax exempt obligations. This includes bonds issued for single family housing, student loans, and nonprofit hospitals and colleges as well as industrial development bonds (IDBs). More than $25 billion were issued in 1981, up from $8.5 billion in 1976. Private purpose bonds accounted for 24 percent of the long term tax exempt bond market in 1976, but rose to 48 percent in 1981. The Treasury Department estimates that 55 percent of the tax exempt bonds sold in 1982 will be for private activities. The volume of tax exempt pollution control obligations issued for private businesses was $3.8 billion in 1981, representing approximately 7 percent of the entire long term tax exempt market, and will be an estimated $4.2 billion in 1982.

The largest growth has occurred in small issue IDBs, which allow virtually any business to obtain tax exempt financing for land or depreciable property. Small issue IDBs have been used extensively by the largest corporations in the country. For example, one of the largest retailing chains has used small issue IDBs to finance $240 million of facilities since 1976. Small issue IDBs marketed in 1981 were an estimated $10.5 billion of the total $25 billion of private purpose bonds. Small issues represented 20 percent of the entire long term tax exempt market in 1981, as compared with only 4 percent in 1976. The estimated revenue loss to the Federal Treasury from small issue IDBs alone will be $1.65 billion in fiscal 1982 and will exceed $2.1 billion in fiscal 1983 unless additional restrictions are imposed. Moreover, we estimate that less than 15 percent of the new investments made in 1981 that were eligible for small issue IDB financing were in fact financed by that method. This means that the potential for future growth in the volume of small issue IDBs remains enormous.

The proliferation of private purpose tax exempt bonds -- along with reduced demand for tax exempt bonds by institutional investors and the tax rate reductions and other structural tax changes enacted in the Economic Recovery Tax Act -- has contributed to a significant narrowing of the difference in interest rates between tax exempt and taxable bonds. While the tax exempt rate historically has been about 65 to 75 percent of the taxable rate, issuers of tax exempt bonds currently have to pay about 80 to 85 percent of the taxable rate. This erosion of the relative advantage of tax exempt financing has increased significantly the interest costs incurred by state and local governments in financing essential public services and facilities.

The increasing volume of private purpose tax exempt bonds has also caused mounting Federal revenue losses. We estimate that the total Federal revenue loss from private purpose tax exempt bonds outstanding in fiscal year 1981 was $3.22 billion and will be $4.19 billion for fiscal 1982.

The proliferation of tax exempt bonds has made them less cost-effective as subsidy mechanisms for private activities. Tax exempt financing has often been criticized as an inefficient means of granting Federal subsidies. The revenue loss to the Treasury from the income tax exemption is significantly greater than the interest cost savings to users of the bond proceeds. For example, if we assume that an investor in the 40 percent bracket purchases a bond bearing interest at 70 percent of the taxable rate, the Treasury loses $1.33 for every $1.00 of interest savings to the bond user. Even more of the benefit is siphoned off by investors as tax exempt bond rates grow closer to taxable rates, as they have recently.

These and other considerations have caused us to conclude that additional restrictions are needed to reduce the growth of private purpose tax exempt obligations. The specific details of our proposal are described in the general and technical explanations released by the Treasury Department on February 26. Copies of those explanations are attached to this statement.

The special provision for small business under our proposal relating to small issue IDBs should be of particular interest to this Subcommittee. Under the Administration's proposal, small issue IDBs will be retained for businesses that have capital expenditures of less than $20 million over the 6-year period from 3 years before to 3 years after the issuance of the bonds. In addition, no single firm will be able to have over $10 million of IDB-financed facilities at any one time. However, subject to these restrictions, small issue IDBs could be marketed as a part of a composite or umbrella bond issue. These changes will make it easier for small and medium-sized businesses to use small issue IDBs and will prevent the use of small issue IDBs by large corporations that are able to raise funds readily in capital markets without an interest subsidy from the Federal government.

I would now like to discuss the policy considerations relating specifically to tax exempt financing for pollution control facilities and the SBA guarantee program.

It is often argued that Federal assistance for construction of pollution control facilities is justified because pollution control requirements are special burdens imposed on businesses by government. However, in our view the cost of controlling pollution should be regarded as part of the cost of producing goods and should be reflected in market prices. The consumption of goods produced by techniques that create air or water pollution as a by-product will be excessive if the market prices of those goods do not reflect all production costs. Thus, providing tax exempt financing for investments in pollution control facilities produces undesirable economic distortions, in that it results in a higher level of investment in polluting industries and a lower level of investment in other economic activities. Another result of the subsidy is that part of the cost of controlling pollution is borne by taxpayers in general, rather than by the purchasers of the goods produced.

Tax exempt financing for pollution control facilities also has been justified in the past by the need to assist businesses in bringing existing plants into compliance with new pollution control requirements. Now, however, most pollution control bonds are issued to finance pollution control facilities for new plants rather than existing plants. Thus, the "transition rule" argument for the tax exemption is no longer applicable in the majority of cases. Furthermore, it is difficult in many cases to determine what portion of a newly constructed plant constitutes pollution control facilities, particularly if the plant employs new or innovative processes or equipment rather than facilities of a type that have previously been recognized as qualifying for tax exempt financing. This inevitably creates an undesirable bias against new technology and in favor of particular types of pollution control equipment which are recognized as eligible for tax exempt financing.

Providing Federal guarantees for tax exempt obligations raises additional problems. Placing the credit of the United States behind an obligation that is exempt from Federal taxation creates a security which is superior in the market to the direct obligations issued by the Federal government. A Federally guaranteed tax exempt obligation also has a distinct competitive advantage over all other tax exempt obligations issued by State and local governments. As a result, Federal guarantees of tax exempt obligations increase the borrowing costs of Federal, State and local governments. Because of these and other considerations, the Treasury Department has consistently opposed Federal guarantees of tax exempt obligations. Moreover, the Public Debt Act of 1941 prohibits the Federal government from issuing tax exempt obligations directly; and numerous other statutes preclude Federal guarantees of tax exempts in other contexts. Allowing SBA guarantees of tax exempt pollution control obligations would be directly contrary to the policies expressed by Congress in those enactments.

Finally, in these times of budgetary constraint, we believe that SBA guarantees of tax exempt obligations would represent an unwarranted duplication of Federal benefits. Both the SBA guarantee and the income tax exemption are implicit subsidies that reduce the interest rate that borrowers must pay. In view of the pressures on the tax exempt bond market and the inherent inefficiencies involved with using tax exempt financing as a subsidy mechanism, we believe that it is appropriate for the Small Business Administration to restrict its guarantee program to taxable financings.

I will be happy to answer your questions.

Mr. RANGEL. Mr. Stewart.

STATEMENT OF MILTON STEWART, EDITOR, INC. MAGAZINE, BOSTON, MASS., REPRESENTING SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, SMALL BUSINESS UNITED

Mr. STEWART. I am appearing here for the Smaller Business Association of New England, which is part of Small Business United.

For more than 25 years, I have been concerned with small business and its needs in our country. Most recently, in the public service, as Chief Counsel for Advocacy at the Small Business Administration. I have served as the lay president of two small business groups, the National Association of Small Business Investment Companies and the National Small Business Association.

I presently edit Inc., the Nation's leading magazine for small, growing companies. This keeps me in daily contact with many kinds of entrepreneurs and small business people.

In my appearance here, based on all of my experience, past and present, it is to urge you as strongly as I can not to diminish in the slightest the flow of industrial revenue bonds credit which presently reach small business.

There is no adequate substitute for it in the private sector, particularly in this period of punishing interest rates.

To the extent that there have been abuses of IRB's, the greatest care must be taken to limit remedies exactly and solely to those abuses. To make industrial revenue bonds more difficult to use in general, and that is unfortunately what Treasury is recommending, is to tamper with an indispensable source of small businesses' badly needed credit for survival and expansion.

I have five brief points which I think should be in the forefront of the minds of every member of this committee as he looks at IRB's. First, IRB's are essential for job creation. The studies of MIT's Prof. David Birch, now reinforced by studies in California and by studies in Europe, emphasize that small business has a critical role in job creation.

Three-quarters of the new jobs created in this country are created in firms with fewer than 20 employees. More than one-fourth presently in this period of recurring recessions and long-term inflation, more than one-fourth of the Nation's labor market areas have more than 20 percent more unemployment than the national average.

That puts over 1,100 labor market areas that have unemployment of more than 10 percent. The Treasury's proposed restrictions could not be more ill-timed.

Second, IRB's are an irreplaceable source of scarce expansion credit for small business. Let me digress for a minute.

Small business has three unmet needs in this country so far as money is concerned. No. 1, is seed capital, the money to really start a business.

No. 2 is equity capital for normal growth companies and against super-growth companies which venture capital sources now pretty well meet the needs of.

Finally, expansion credit for the business which has to survive by growing. That kind of credit in a market like today is almost impossible for the normal small firm to find without paying interest rates far beyond what its bottom lines can support.

To illustrate how important we consider IRB's, we began a study published in our magazine last October, known as "Report Card on the States," to appraise the relative attractiveness to entrepreneurs and small business of the 50 States in the Union.

We went through enormous statistical gyrations and consulted with hundreds of people to determine the standards to be used.

One of the standards we used last October was the utilization by the States of IRB's, because we felt their availability in a particular State was a mark of State concern with the growth and the formation of new small companies.

Now, our concern is with the fastest growing companies. Not every State makes the same use of IRB's. There is no perfect correlation of this. California, for example, according to our tables, which come from CBO, doesn't use this kind of IRB. It has still, nevertheless, a very high number of super-growth companies.

Other States, however, which have less favorable climate characteristics than California, must rely on IRB's if we are to have anything like an equality of opportunity to grow among the States.

The loss in revenue from IRB's is minimal. It is, in my opinion, more than offset by unrecognized revenue gains from consequential economic growth, where IRB's are used. We have given you as an appendix to this study. We are very aware of the burden you are under for material, so we have just given you a summary of a study done by two University of Chicago professors financed by the Small Business Foundation which we think demonstrates that the cost of IRB's is far less than the Treasury estimates.

Fifth, IRB's are a hopeful example of how a revived federalism should work. For Treasury and Congress to make them less usable now is self-defeating. Small business growth is essential for State and local economies and to limit needlessly the future underpinning of their economies is to raise the gravest questions about the seriousness of the talk about a new federalism.

Finally, while I vigorously support a reasonable limitation on availability of IRB's to small business, I am equally strongly opposed to Treasury's recommendations. They do not preclude abuses. They would impede the proper functioning of the mechanism itself.

The most obnoxious of Treasury's proposals would deny accelerated depreciation treatment to IRB-financed projects. As of now, 2,000 of the Nation's largest companies will get 80 percent of the benefits of the ADC provisions. Here is Treasury back again to tilt the benefits even further against small business.

If a small business is lucky enough to be able to find IRB financing for a plant, it seems to me we ought to applaud it rather than punish it by trying to deprive it of ADC.

If the Treasury is so concerned with the loss of revenue, it might look at the fact that the same 2,000 companies that get 80 percent of the benefits under ADC, are the same 2,000 companies that get 80 percent of the benefits under the investment tax credit, a far more costly tax expenditure for the people of this country.

That is all I have to say, Mr. Chairman, except to say we will be happy to furnish anything you like in support of the arguments we have made here.

Thank you very much.

[The prepared statement and attachment follows:]

STATEMENT OF MILTON D. STEWART, EDITOR, INC. MAGAZINE, ON BEHALF OF SMALL BUSINESS ASSOCIATION OF NEW ENGLAND

For more than 25 years I have been concerned with small business and its needs in our country. I presently edit the nation's leading magazine for small growing companies.* This keeps me in daily contact with many kinds of entrepreneurs and small business people. My appearance here is on behalf of the Smaller Business Association of New England, one of the oldest and most respected small business groups in the Nation. Based on all my experience, past and present, I urge you as strongly as I can not to diminish in the slightest the flow of industrial revenue bond credit which reaches small business. There is no adequate substitute for it in the private sector, particularly in this period of punishing interest rates. To the extent that there have been abuses of IRBs, the greatest care must be taken to limit remedies exactly and solely to those abuses. To make industrial revenue bonds more difficult to use in general--and that is unfortunately what Treasury is recommending--is to tamper with an indispensable source of small business' badly needed credit for survival and expansion.

These are the principal points that this Committee should bear in mind:

1. IRBs are essential for job creation (see studies of MIT Professor David Birch and others on small business' critical role in job creation) in a period of recurring recessions and long-term stagflation. More than one-fourth of the Nation's labor market areas have more than 20% more unemployment than the national average. The Treasury's proposed restrictions could not be more ill-timed.

2. IRBs are an irreplaceable source of scarce "expansion credit" for small business. Inc. specifically included their utilization as a measure of a state's economic attractiveness in its first "Report Card on the States" last October (See Appendix II.)

3. The loss in revenue from IRBs is minimal. It is, in my opinion, more than offset by unrecognized revenue gains from consequential economic growth. (See Summary of Study by Kormendi and Nagle, Appendix I.)

4. IRBs are a hopeful example of how a revived Federalism should work. For Treasury and the Congress to make them less useable is self-defeating. It limits needlessly the future underpinning of state and local economies. Small business growth is essential for them; a Federal failure to see this raises grave questions about the seriousness of the talk about a new Federalism.

5. While I vigorously support a reasonable limitation on availability of IRBs to small business, I am equally strongly opposed to Treasury's recommendations. They do not preclude abuses; they would impede the proper functioning of the mechanism itself. The most obnoxious of Treasury's proposals would deny accelerated depreciation treatment to IRB-financed projects. As of now, 2,000 of the Nation's largest companies will get 80% of the benefits of the ADR provisions. And here's Treasury back again to tilt the benefits even further against small business.

*Milton D. Stewart has served as editor of Inc. Magazine since March, 1981. Inc., a magazine for growing small companies, reaches over 400,000 readers each month. In less than three years, it has built a circulation which the other leading business periodicals took more than a quarter of a century to achieve. Mr. Stewart's career, in addition to journalism, includes small business and venture capital management, law practice, and government service. As a small businessman, he served as the lay president of two national small business organizations--the National Association of Small Business Investment Companies and the National Small Business Association. He organized and later headed one of the country's largest venture capital firms. He has been involved as a lawyer, a venture capital manager or a director with many small firms in every part of the country. Mr. Stewart was appointed by the President and confirmed by the U.S. Senate as the first Chief Counsel for Advocacy of the National Small Business Administration (1978-1980). During this period, he served as counsel and presiding officer of the 1980 White House Conference on Small Business.

APPENDIX I: Study of "THE NATURE AND EFFECTS OF SMALL-ISSUE INDUSTRIAL DEVELOPMENT BONDS" By Roger C. Kormendi and Thomas T. Nagle

Findings of THE KORMENDI STUDY

-- The United State Treasury artificially exaggerates the loss of its revenue caused by tax-exempt Industrial Revenue Bonds. Whereas the Treasury estimates that each $1 billion of IRBs results in an annual revenue loss of $30 million, the Kormendi study shows that the revenue loss is much smaller - only $4.2 million per $1 billion of IRBs.

The real revenue loss to the Treasury is even less, as Kormendi still does not count increases in tax revenues arising from the increased investment and productivity stimulated by IRBs. Adding Kormendi's figures to the CBO's own estimates of increased investment and tax revenues due to IRBs shows IRBs to be producing revenue gains for the Treasury - a point also made by Norman Ture in a study prepared by him before his appointment as Undersecretary of the Treasury.

-- The reason the Treasury and CBO estimates are so far off is that they are based on an unrealistic assumption. The Treasury assumes that bond holders would substitute tax-exempt holdings with fully taxable bonds if IRBs were eliminated. Common sense indicates that in the real world, this is not the case. Instead, lenders would shift their funds into investments taxed at lower marginal tax rates, such as equity, rather than into investment yielding fully taxable income.

-- The Treasury also ignores the effects of inflation. Inflation causes "disintermediation" in financial markets, thereby decreasing the funds available to local banks to lend to smaller companies. Only public borrowers (state and local governments) can issue tax-exempt bonds, so inflation shifts capital to public borrowers and away from private companies. IRBs offer private employers a chance to compete with the tax-free public sector for capital.

-- Kormendi considers IRBs as part of the nation's interconnected credit markets. When this reality is acknowledged, the effect of an additional $1 billion of IRBs on other tax-exempt interest rates is only one-sixth the amount previously estimated. In other words, an additional $1 billion of IRBs would slightly raise the cost of all tax-exempt borrowing, but only by approximately .6 basis points (6/1000ths of a percentage point).

-- Kormendi also shows that the Treasury's estimate of $1.33 of tax loss per $1.00 of benefits to small business is completely erroneous. The Treasury once again ignores the fact that lenders would not substitute taxable bonds for tax-exempt bonds. When the real alternate investments are considered in this study, it is found that for every $1.00 in benefits to the small company, there is only a $.15 loss to the Treasury.

-- In other words, Kormendi concludes that IRBs are more than six times as efficient as the federal government's direct subsidy programs to increase employment through investment assistance.

A Summary of
THE NATURE AND EFFECTS OF SMALL-ISSUE INDUSTRIAL DEVELOPMENT BONDS

by

Roger C. Kormendi
Thomas T. Nagle
University of Chicago

This study examines several issues related to the use of Industrial Development Bonds (IDBs). Much of the analysis and many of the conclusions in this study differ from widely cited studies by the Congressional Budget Office and the U.S. Treasury. Our purposes in this study are (1) to develop a more realistic view of the way capital markets adjust to small-issue IDB financing and (2) to derive estimates of the effects of IDBs that are consistent with this more realistic view. Our findings are the following:

- The cost of IDB financing in foregone federal tax revenues is at most $6 to $8 million dollars for each billion dollars of new IDBs when taxable interest rates are in the range of 10% to 14%. These estimates contrast sharply with the CBOs recent estimates of $30 to $40 million for each billion dollars of bonds.

- These revenue loss estimates imply that each dollar of interest saving for IDB borrowers costs the U.S. Treasury at most 20¢ in federal tax revenues. Thus IDBs are at least five times as efficient as direct subsidies, which cost the U.S. Treasury one dollar for each dollar of benefit. This conclusion contrasts sharply with the Treasury's claim that each new dollar of interest saving for IDB borrowers costs the U.S. Treasury $1.33 in federal tax revenues.

- The reason the widely cited CBO and Treasury figures are so inflated is that they are based on assumptions about investors' portfolio holdings that simply do not conform to the facts. Their analysis is equivalent to assuming that newly issued IBDs are absorbed only by investors around the 30% marginal tax bracket and that when those investors purchase tax-exempt bonds only fully taxable bonds are replaced. In fact, newly issued IDBs are generally absorbed by the full spectrum of investors above the 30% tax bracket, replacing in those investors' portfolios assets such as equity that, like tax-exempt bonds, are only partially taxed. The equity released by high tax bracket investors is in turn absorbed by the full spectrum of lower tax bracket house-holds and non-taxed institutions in lieu of taxable bonds.

- Inflation causes a shift of funds out of taxable bond markets into tax-exempt bond markets. This is because under current tax law taxes are levied not only on "real" interest income but also on that part interest income that simply compensates investors for the effects of inflation. Thus, funds that would otherwise be available for financing private investment through taxable bond and loan markets are diverted by inflation into tax-exempt bond markets, which traditionally have been the exclusive domain of public borrowers. The result has been a substantial reduction in tax exempt interest rates relative to taxable interest rates corresponding to the higher rates of inflation in recent years. IDBs offer the only currently available avenue for private investment projects to regain access to the funds diverted to tax-exempt markets as a consequence of inflation.

1993

THE NATURE AND EFFECTS OF SMALL-ISSUE INDUSTRIAL DEVELOPMENT BONDS

by

Roger C. Kormendi and Thomas T. Nagle

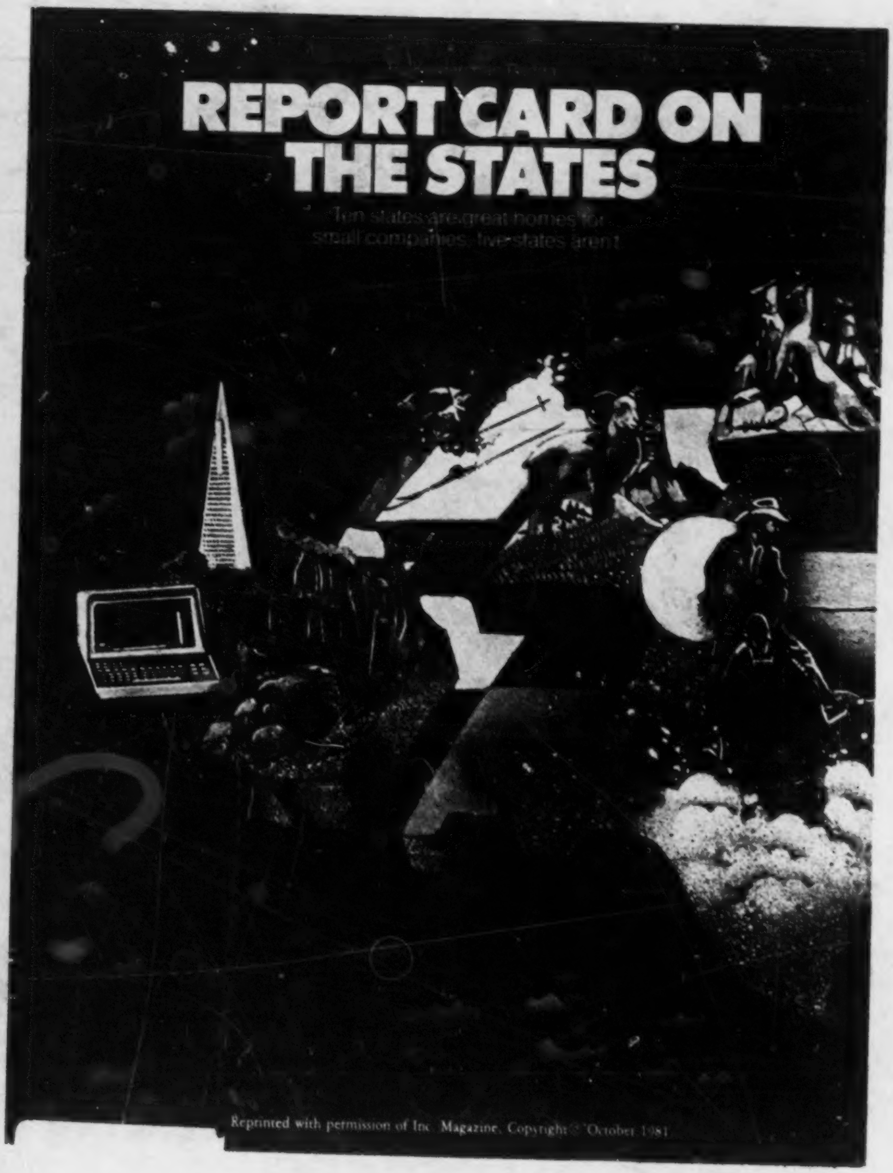
I. INTRODUCTION

Scope of This Study

Small-issue industrial development bonds (IDBs) have in recent years become an important source of capital for small business. Such financing has provided benefits to the firms that acquired funds from these bonds, and it no doubt has also involved some costs. As small-issue IDBs have increased in prominence, the estimation of the costs, particularly the effects of increased tax-exempt financing on interest rates and federal tax revenues, has been widely debated.[1]

In this study, we argue that an overly simplistic view of capital markets has substantially exaggerated most estimates of the effect of small-issue IDBs on interest rates and on federal tax revenues. Most studies, notably those from the U.S. Treasury and the Congressional Budget Office, have simply ignored the numerous opportunities that investors have to substitute tax-exempt bonds for a wide variety of other assets. As a result, those studies have failed to recognize that even

Tax exempt revenue bonds have often been alledged to disrupt tax exempt bond markets by significantly driving up tax exempt interest rates. One estimate that has been widely cited by both the CBO and the Treasury claims that each additional $1 billion of tax-exempt bonds would raise tax-exempt interest rates by 5 to 7 basis points. Our study finds that when lagged portfolio adjustments, the effects of inflation, and the integrated structure of capital markets are all properly accounted for, the effect of each additional $1 billion of tax-exempt bonds is only 0.6 basis points, or approximately one-tenth the widely cited estimate.



REPORT CARD ON THE STATES

Ten states are great homes for small companies; five states aren't

Reprinted with permission of Inc. Magazine, Copyright © October 1981.

Ask any small businessman which state has the best business climate, and you can bet he'll give his home state as the answer. At a different time, ask the same businessman which state has the *worst* business climate and you can bet he'll give you his home state as the answer.

To bring some objectivity to the process of analyzing the business climate in each of the 50 states, INC. researched over 50 factors in six areas of doing business: tax burdens, labor, capital resources, official commitment to small business, energy costs, and quality of life. We have ranked the top 10 states in each of the six areas. The rankings and an explanation of the factors involved in each ranking begin on page 92.

In addition, INC. decided to give each state a report card based on the combi-

nation of five of the individual rankings (excluding quality of life, which is so subjective). We've assigned each state a letter grade, from A through F, and published each report card in the table on pages 96 and 97. The results (10 A's, 18 B's, 11 C's, 6 D's, and 5 F's) are often surprising. You wouldn't think, for instance, of **North Dakota** and **Idaho** as states rating an A for small business climate. Both follow much the same formula for getting that grade: very high rates of small business activity (number of small companies per 1,000 population), excellent labor conditions, and light tax burdens. Both states share the same failings: weak official commitment to small business on state programs and limited capital available to home-state businesses. Idaho, in particular, gets good grades for its lower energy costs.

Minnesota has a fairly heavy tax burden, but gets an A for its efforts to attract high-technology companies. The state is one of the top five in its official sensitivity to the needs of small business, and offers a large pool of capital to its entrepreneurs. **Colorado** gets an A from its above-average labor climate, its light tax burden, and a positive ranking in the cost of energy.

Both **Arizona** and **California** get an A because of their governments' respective commitments to helping out small business. Beyond that similarity, the two states diverge: Arizona has a light tax burden, low energy costs, and a good labor situation, although it doesn't offer entrepreneurs much in the way of capital resources. California, on the other hand, has the second largest pool of venture capital, but is seriously weakened by high taxes and high labor costs.

While no state in the Northeast earned an A, four southern states came out tops: Texas, Mississippi, Alabama, and North Carolina. If any state could be pegged as Number 1 overall as a place to run a small company, **Texas** would be the one. (We wanted to avoid ranking the states' overall climates because the decision about where to do business is so complex that it grossly oversimplifies the problem to say that one state is the best place for all small businesses.) Texas made the top 10 in labor, taxes, and capital resources: more top rankings than any other state. Though **Alabama** is hurt by its labor climate, the

THE TOP 10 STATES IN SIX CATEGORIES

CAPITAL RESOURCES
1. New York
2. California
3. Massachusetts
4. Connecticut
5. Minnesota
6. Texas
7. Pennsylvania
8. Alabama
9. New Jersey
10. Mississippi

One of the biggest headaches every entrepreneur faces is the task of raising seed capital. And if his company not only survives but grows, he often must raise second and third phase financing as well. This ranking measures the availability of that money by gauging the "looseness" or "tightness" of investment capital in the 50 states. In which states do the money sources seem most willing to invest in young and growing companies?

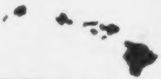
Not surprisingly, the top 10 include most of the acknowledged money centers in this country. The only ones conspicuous in their absence are Illinois and Florida. Illinois's failure to make the top 10 list reflects an extremely low Small Business Investment Company activity and Industrial Revenue Bond issuance rate ($4 per capita vs. the national average of $40 per capita). Florida, which ranks No. 47, lacks a loan program tailored to small business and satisfactory IRB issuance. Florida is further hindered by a conservative banking community.

New York achieved the No. 1 position through an extremely aggressive banking community as well as a preponderance of venture capitalists and other investors willing to risk participation in startups and young companies. California also boasts an aggressive banking community, high SBIC activity, and, like New York, a large number of investors willing to take risks.

Massachusetts, Connecticut, and Minnesota all have aggressive banking communities and active SBIC programs. Connecticut, in fact, is the national leader in SBIC activity. Minnesota and Massachusetts possess very active IRB programs as well.

Pennsylvania and Alabama are hobbled by a lack of small business loan programs. But they both managed to make the top 10, the former by claiming the nation's most active IRB authority and the latter by registering the second most active SBIC program. Mississippi overcame the handicap of a cautious banking community to earn a top slot by promoting the second most active IRB authority along with a well-run SBIC program.

Anchoring the opposite end of the spectrum, West Virginia finds itself in the company of Nevada, Nebraska, Kansas, Alaska, and Hawaii. Geographically a rather diverse crew, these states can all be characterized as having average to nonexistent IRB sales and SBICs. All except Alaska are also the victims of banking communities that are recalcitrant when it comes to lending.



ENERGY COSTS
1. Hawaii
2. Alaska
3. Washington
4. Montana
5. Oregon
6. Wyoming
7. Idaho
8. Maine
9. Louisiana
10. Florida

Hawaii number one? A Sunbelt oil producer like Texas or Oklahoma would seem to be a more logical choice. How could an island that is forced to import all its fuels have the lowest energy costs? The answer lies in Hawaii's climate.

The formula used for calculating energy costs took into account the raw cost per Btu for electricity, heating oil, and natural gas. The formula calculated the percent use of oil and natural gas for heating and then constructed the total heating dollar by multiplying the percent use times the raw cost for each fuel. This figure was then plugged into a formula incorporating the number of heating days, while the price of electricity was factored into the number of cooling days. Also taken into account were the electricity costs involved in day-to-day operations, such as office lighting and running plant machinery.

Thus, despite some of the highest energy costs, Hawaii, with a climate tempered by ocean breezes, has no heating bills. Alaska, on the other hand, despite a large number of heating days, managed to score well due to no cooling bills and the availability of natural gas at one-third the national average cost. Limited cooling needs also earned Maine a position among the top 10.

Washington and Oregon ranked high, based on dirt-cheap electricity provided by abundant hydroelectric power. Montana and Idaho attribute their low energy bills to a combination of very cheap

A NOTE FROM THE EDITOR

INC.'s first Special Report on the state's small business climates must be read with care because it is a *first* report. We know from our experience with similar surveys that it takes two to three years of doing a particular report to find the best and most comprehensive ways of compiling them. We think this first report on the states gives as fair and accurate a picture of those factors analyzed as possible. We also know that each state can make a better case for its own achievements in its appeals to some particular kind of business or industry.

We will, however, engage in a continuing technical review of how to improve this report during the next year. We will talk with state officials, academic specialists, and small business leaders. And we will be particularly interested in our readers' response to the report, for which we've provided a postpaid card bound in at a page 94.

During the next months, we will also study what the executive and legislative branches of each state's government is doing to specifically improve its attractiveness to small businesses. We will select for special citation those states that haven taken the most promising steps for small business in certain areas: taxes, regulation, paperwork, capital, credit, procurement, data collection, management assistance, and others.

In 1980, the National Governor's Association adopted a resolution at their annual meeting in Denver, Colo., which signaled a higher priority for small business at the state level. In part it said, "From a state and local economic development standpoint, small businesses offer considerable potential for ensuring economic diversity, stability, and long-term growth. The governors pledge their cooperation in working at both the state and national levels to encourage the growth and development of America's small business."

Since that conference, we've heard of some promising beginnings in what we think could be called the "50 State Small Business Sweepstakes," in which there are literally no losers.

—Milton D. Stewart, Editor

electricity generated through hydro power and petroleum, as well as the availability of natural gas and heating oil at well below the national average cost. Wyoming, too, claims low electricity costs, through cheap coal. It also has natural gas at costs well below the national average.

At the bottom of the rankings are the Middle Atlantic and southern New England states. Spanning an arc from Virginia to Massachusetts, these states are beset by hefty heating and cooling costs, but lack the cheap energy available to western states lying at the same latitude.

SMALL BUSINESS COMMITMENT

1. California
2. New York
3. Minnesota
4. Massachusetts
5. Kentucky
6. Illinois
7. Wisconsin
8. Michigan
9. Connecticut
10. Ohio

Visit almost any state in the nation and you will hear the familiar complaint, "Our state government is one of the worst. The fellas in the state capital just don't care about small business." Same old belly-aching you say? Not if you are talking with an entrepreneur from Nevada, Wyoming, or South Dakota. All three states rank among the bottom 10 in terms of budget policies and commitment to small business programs. South Dakota, in fact, is No. 50 in this respect.

INC. analyzed the level of support among state legislatures for small business, as well as their attitude toward expenditures and revenues in general. These factors (see table on page 96) were correlated in a computer model to generate a ranking of the 50 states based on their support of small business.

The top 10 found their niche through solid commitment to small business programs, such as procurement setasides, advisory offices, and significant legislative activity favoring smaller enterprisas. It is essentially the strength of these programs rather than the presence of balanced budgets that propelled them to the head of the pack.

LABOR

1. North Dakota
2. South Carolina
3. North Carolina
4. Idaho
5. Florida
6. New Mexico
7. Utah
8. Texas
9. New Hampshire
10. Kansas

Armed with a labor force that is willing to work for one of the lowest wage rates in the country and that does not believe in striking, North Dakota tops the list in the labor category. The only Achilles' heel the state exhibits is a rather tight labor pool, with one of the lowest unemployment rates in the country.

The ranking took into account many factors including union strength, militancy, and recent success in recruiting; wage rates; and the ability to find skilled workers to fill both blue- and white-collar positions.

Taking second and third place are South Carolina and North Carolina. Their strength lies in the fact that their workers get paid the lowest and third lowest wage rates, respectively, in the country and are the least unionized work forces as well. In fact, the Carolinas are organized at a level that is less than half the national average, and incredibly, this level has been decreasing in recent years. North Carolina's shortcoming is that it possesses a scarcity of skilled workers for blue-collar jobs, while South Carolina has a severe shortage of workers for white-collar positions. To compensate for these weaknesses, both states are funding two of the most extensive vocational programs in the country. Idaho's major selling points are a low strike rate and the fact that it is undergoing one of the most rapid deunionization rates. Florida and New Mexico boast two of the lowest wage rates as well as a very low strike rate among two of the least unionized work forces in the 50 states. Florida also spends the highest amount per worker on vocational training programs.

Utah has a well-trained, nonunion work force, but it also has a high wage rate and the manpower is in a tight market marked by low unemployment. Texas and New Hampshire have low unionization levels. New Hampshire also has a low wage rate but suffers from a tight labor market and a poorly funded vocational program.

Among those ranked at the bottom of the list are Indiana, West Virginia, Hawaii, Missouri, state shows exceptional performance in capital resources. **Mississippi** is helped out by its capital resources, primarily distributed through Industrial Revenue Bonds. And **North Carolina** gets particularly good grades for its labor pool and a low tax burden.

The second tier of states, those that got a B, include most of the industrial states in the country. **New York** and **Massachusetts**, for example, have enormous pools of capital for small business people, but also suffer from high taxes and energy costs. **Arkansas**, on the other hand, offers the fifth-best tax structure and reasonable energy costs, but has little capital. And **Maine** has an above-average small business activity rate, inexpensive labor, and insignificant cooling costs, but its economy is one of the most depressed in the country.

Pennsylvania and **Illinois** both got C grades, surprisingly. Those Philadelphia banks help their state get a top-10 ranking in capital resources, but the state is hurt by high taxes, high energy costs, a poor labor picture, and an abysmal rate of small business activity. Illinois, on the other hand, has a surprisingly strong commitment to small business through government programs and a fair amount of capital, but is hurt by its labor and energy costs.

Iowa and Maryland are surprising states to get a D on small business climate. While **Maryland** has an awakening interest in small companies, particularly high-technology firms, it ranks in the bottom 10 for its tax burden and its energy costs. And **Iowa** scores well in its tax structure and its government support of small business, but is hurt by a tight labor supply and a shortage of venture capital.

The five states that earned a failing grade are, perhaps, most interesting of all 50. **Hawaii** is a great place to visit, but it's a tough place to run a business. It has the lowest energy costs in the country, but it's number 49 in taxes, number 48 in labor, and gets poor marks for capital resources and official support for small business. **West Virginia**'s government is sensitive to small business, but the state ranks in the bottom five for labor, taxes, and capital resources, and has the lowest rate of small business activity in the country.

Delaware ranks in the bottom five in

Michigan, Pennsylvania, Ohio, and Oregon, where workers earn among the highest hourly wages in the nation and are unionized at two to four times the level of workers in the top 10 states. The union activity in these lowest ranked states is marked by militancy and memberships that are much more willing to pursue job actions to achieve their goals.

TAXES
1. Nebraska
2. Arizona
3. Texas
4. Indiana
5. Arkansas
6. New Hampshire
7. North Dakota
8. Missouri
9. South Dakota
10. Colorado

Tax rates, it can be argued, are the most important factor in any comparison of state business climates. However, it is often the presence of nontaxation or exemption from taxation that can be the critical element in a fledgling company's survival and growth. Unfortunately, the wide diversity of small business makes it impossible to quantify the exemptions (see table on page 96) offered by each state.

To quantify tax policies for a state-by-state ranking, INC. weighed the tax burden per capita, the recent trends in that burden, and the future trend based on state debt. The tax burden borne by small business was not used because timely and accurate data is not available. Unemployment related taxes, however, were incorporated to more closely approximate the cost of operating a business in each state in tax terms. Nebraska, for example, emerges as No. 1 due to strong performance in all categories but particularly because of a very low employer contribution rate to the state's unemployment compensation fund.

Arizona claims very low debt per capita, leading to the expectation of a low tax rate in the future. The state also has a wealthy unemployment compensation fund that promises low unemployment taxes in the future.

Texas has low debt per capita, but even more important is the absence of a corporate or personal income tax. The Lone Star State also has the lowest employer unemployment contribution rate.

Arkansas scores well in all categories and is especially notable for one of the lowest percentage increases in taxes from 1979 to 1980.

Claiming the lowest taxation rate in the country, New Hampshire has not only avoided taxing personal income but has also kept the lid on its unemployment contribution rate.

North Dakota has a low tax rate, a small debt, and its taxes rose the least in the nation from 1979-80.

Low tax burdens also earn Missouri, South Dakota, and Colorado top 10 rankings.

As expected, states like Massachusetts, New York, and Minnesota, with notoriously high tax rates, are standouts among the bottom 10 on the list, with Alaska earning the dubious distinction of worst case.

QUALITY OF LIFE
1. North Dakota
2. Iowa
3. South Dakota
4. Wyoming
5. Hawaii
6. Rhode Island
7. New Hampshire
8. Vermont
9. Montana
10. Florida

Could North Dakota rank first in quality of life? Where's California, that mecca of sunseekers and trendsetters? The answer lies in how the quality-of-life factors were tabulated. Unlike the other rankings, for which it was possible to create fairly accurate models that evaluated various factors on the basis of their importance to small business, the quality of life is something that is totally subjective. For example, how does one explain to the ski buff in Colorado that Florida's beaches contribute more to the quality of life than ski trails?

In fact, it is impossible to weight factors for differing lifestyles in the same scale. To establish some measure, however, INC.'s computer selected the states that were the best for the lifestyles they represent. The factors incorporated in the calculations ranged from cultural elements such as orchestras and opera, to quality of health care and education, recreational facilities, and the cost of living. The result is a list of 10 states that represent the best of their breed when personal preferences are considered.

North Dakota, for example, earns top billing on the basis of its crime rate (lowest in the nation), long life expectancy, and lower cost of living. Ditto Iowa, New Hampshire, and Vermont. If your preference, however, is culture, health care, and other factors associated with living near metropolitan areas, then Rhode Island, Massachusetts (No. 13), or New York (No. 14) are good bets. Sun, surf, and sand? Hawaii or Florida.

And what about California? Based on high cost of living, a tight housing market, and a high crime rate (second in the nation), the Bear Republic emerges as No. 32, just behind Minnesota and North Carolina and just ahead of Oregon and Pennsylvania in a ranking best left to humans.

STATE	INC. overall rating[1]	TAXES[2]			CAPITAL RESOURCES[4]				
		Per capita	Unempl.	Exemptions[3]	SBIC index	IRB issues per capita	Gen. obl. bonds	State loans	Bank loans[5]
Alabama	A	$ 493	2.6%	C, PE, L, M, I, N, R	276.53	$ 66	NO	NO	15.5%
Alaska	D	3,541	4.8	E, N	23.78	0	YES	YES	19.7
Arizona	A	688	2.2	C, P, I	24.59	45	NO	NO	15.6
Arkansas	B	532	2.1	I, N	32.64	45	NO	NO	13.6
California	A	853	3.4	I	116.42	0	NO	YES	18.9
Colorado	A	538	1.3	C[8], PE, N	106.92	15	NO	NO	17.8
Connecticut	C	591	2.6	P[9], M[10], I	388.04	31	YES	YES	17.9
Delaware	F	886	2.8	C, E[11], L, M, I, N	39.21	43	YES	YES	8.5
Florida	B	542	2.0	C, P[9], E[11], I[12], N	80.45	18	NO	NO	10.3
Georgia	B	533	1.9	L, I, N	45.32	31	NO	NO	14.2
Hawaii	F	1,091	2.8	E	40.18	NA	YES	YES	14.4
Idaho	A	542	2.1	I, N	217.11	NA	NO	NO	16.7
Illinois	C	630	3.3	L[13], M, I, N[14]	18.69	4	NO	YES	24.2
Indiana	B	499	1.6	L[15], M, I[16], N	27.31	72	NO	YES	12.1
Iowa	D	602	2.8	C[17], L[18], M[19], I[20]	8.19	45	NO	NO	11.8
Kansas	B	536	1.8	C[8], L[21], M[21], I[22], N[21]	20.85	45	NO	NO	13.0
Kentucky	B	608	2.2	L[23], M[23], I[23], N	49.45	22	NO	YES	13.2
Louisiana	C	595	3.3	C, L[24], M, N, R	116.36	8	NO	NO	16.8
Maine	B	564	3.1	I, N, R	42.10	34	NO	YES	17.5
Maryland	D	665	3.8	L[23], M, I, N, R[25]	39.34	32	NO	YES	13.0
Massachusetts	B	681	3.5	C, M, N, R	140.35	64	NO	YES	23.0
Michigan	D	643	4.1	C, P, L[26], M, I, N	27.17	30	NO	YES	14.5
Minnesota	A	789	2.3	C, PE, L[27], M, I, N[28], R	106.98	99	NO	YES	17.6
Mississippi	A	578	2.1	P, L, M, I, N	133.64	100	NO	YES	12.5
Missouri	F	430	2.3	C, P, N	11.28	NA	NO	YES	14.5
Montana	B	554	2.9	C[29], L, I[30], N[31]	11.34	27	NO	YES	15.4
Nebraska	C	549	1.3	I	.00	19	NO	NO	12.6
Nevada	F	679	3.0	C[9], P[9], I[31]	32.20	NA	NO	NO	14.1
New Hampshire	B	302	1.8	P[9], M, I, N	214.68	62	NO	YES	14.7
New Jersey	D	560	3.7	L, M[19], I, N	87.56	79	YES	YES	14.2
New Mexico	B	746	2.1	M, I	248.59	6	NO	NO	18.0
New York	B	721	3.6	C[32], P[33], E[11], L, M[34], I, N, R	69.15	14	YES	NO	24.2
N. Carolina	A	574	2.1	I, N[35]	50.78	36	NO	NO	18.1
N. Dakota	A	566	2.5	C, E, L[36], M[34], I, R[25]	.00	60	YES	YES	14.5
Ohio	B	444	2.4	C, P, L, M, I, N	44.22	67	NO	YES	14.8
Oklahoma	B	614	1.6	L[21], M, I, N	106.01	96	NO	YES	16.7
Oregon	C	576	3.4	C, PE[37], L[38], I, N	98.06	13	YES	YES	19.4
Pennsylvania	C	617	3.4	E, L, M[38], I[39], N, R	36.25	139	NO	NO	18.2
Rhode Island	D	593	2.9	L, M, I, N, R	24.44	67	NO	YES	20.3
S. Carolina	B	572	2.1	L, M, I, N, R	86.09	68	NO	NO	13.5
S. Dakota	B	393	1.3	C, PE, L, I	201.01	24	NO	NO	13.4
Tennessee	B	431	1.8	P, L[23], M, I, N	22.58	56	YES	YES	14.5
Texas	A	505	.6	C[9], P, L[40], M	117.71	22	NO	YES	21.0
Utah	C	575	1.7	I	35.27	42	NO	NO	18.6
Vermont	C	540	3.3	L, M, I, N	212.24	49	NO	YES	13.6
Virginia	C	528	1.1	L, M[23]	64.72	57	NO	NO	13.7
Washington	C	743	3.3	C[9], PE, L, M, I	126.98	0	NO	NO	25.1
W. Virginia	F	649	2.6	C, PE, N	5.27	18	NO	NO	8.8
Wisconsin	B	713	3.2	C[41], M, I, N	58.94	42	NO	NO	14.8
Wyoming	C	862	1.3	C[9], PE, I	68.35	88	NO	NO	17.0

LABOR[6]			SUPPORT[7]			
% Unempl	% Union	Avg. hourly wage index	Procurement prog.	Assist. office	Advisory board	Legis. committee
7.1	19.2	85	10%	NO	NO	NO
9.2	26.2	147	NO	YES	NO	NO
5.1	13.8	99	YES	YES	NO	NO
6.2	15.0	77	NO	YES	NO	NO
6.2	23.7	104	YES	YES	YES	YES
4.8	15.2	102	NO	YES	YES	NO
5.1	21.9	98	15-25%	YES	NO	NO
8.0	21.7	100	NO	NO	NO	NO
6.0	11.7	79	NO	YES	YES	NO
5.1	13.6	77	YES	NO	YES	NO
6.3	32.1	94	NO	NO	NO	NO
5.7	14.3	100	NO	NO	NO	NO
5.5	31.5	112	YES	YES	NO	NO
6.4	29.3	118	YES	NO	NO	NO
4.1	19.2	118	NO	NO	NO	YES
3.4	12.8	100	10%	NO	NO	YES
5.6	22.4	99	YES	YES	YES	YES
6.7	16.0	103	10%	YES	NO	NO
7.2	18.3	84	NO	NO	NO	NO
5.9	21.0	101	YES	YES	NO	NO
5.5	24.4	90	5%	YES	NO	YES
7.8	34.6	133	YES	YES	NO	NO
4.2	24.4	104	20%	YES	NO	YES
5.8	12.4	72	YES	YES	NO	NO
4.5	30.0	98	NO	YES	NO	NO
5.1	24.1	115	YES	YES	YES	NO
3.2	15.3	100	NO	YES	NO	NO
5.1	22.9	104	NO	NO	NO	NO
3.1	13.3	80	NO	NO	NO	NO
6.9	23.0	101	NO	YES	NO	NO
6.6	12.1	78	NO	YES	NO	NO
7.1	39.2	99	YES	YES	YES	YES
4.8	6.5	72	YES	NO	YES	NO
3.7	14.7	89	NO	NO	YES	NO
5.9	29.5	121	NO	YES	YES	YES
3.4	13.5	99	NO	NO	NO	NO
6.8	23.1	117	NO	YES	NO	NO
6.9	34.2	105	YES	YES	YES	NO
6.6	27.1	77	NO	NO	YES	YES
5.0	6.7	74	NO	NO	NO	NO
3.5	10.3	89	NO	NO	NO	NO
5.8	17.7	81	NO	YES	YES	NO
4.2	11.0	95	10%	YES	YES	NO
4.3	13.0	95	NO	YES	NO	NO
5.1	17.5	85	NO	YES	NO	NO
4.7	12.7	83	NO	YES	NO	NO
6.8	33.1	129	YES	YES	NO	NO
6.7	36.8	110	NO	YES	YES	YES
4.5	27.8	112	YES	NO	YES	YES
2.8	14.9	97	NO	NO	NO	NO

FOOTNOTES

1. grade based on total points accumulated in 5 categories: taxes, capital, labor, small business support, and energy.
2. 1980 per capita data (Bureau of the Census); unempl. is % of total payroll employer pays in unemployment tax (U.S. Employment & Training Admin.).
3. Key: C-corporate income, P-personal income, E-excise, L-land/capital improvements, M-machinery/equip., I-manufacturer's inventory, N-new equip. sale/use tax, R-tax exemption to encourage R&D (Site Selection Handbook, Conway Publications Inc., Atlanta, Ga.)
4. 1980 Small Business Investment Company financing, 100= balance between share of SBIC financing and state economic activity (Small Business Administration); Small issue Industrial Revenue Bonds (Congressional Budget Office); general obligation bonds (Conway Publications); 1980 state loans (Directory of State Small Business Programs, Office of Chief Counsel for Advocacy, SBA)
5. total commercial & industrial loans as % of total bank assets (FDIC).
6. 1980 unemployment rate, seasonally adjusted (U.S. Bureau of Labor Statistics); % unionization (Directory of National Unions and Employee Assns., BLS); average hourly wage & fringe benefits for selected manufacturing (U.S. Dept. of Labor)
7. state government's commitment to small business programs; % procurement indicates percent of state purchases awarded small business (SBA)
8. 10-yr credit for new business based on jobs investment.
9. state does not tax personal income; Nevada, Texas, Washington, and Wyoming also do not tax corporate income.
10. equip. acquired after 1973 exempt from local prop. tax.
11. does not levy excise tax.
12. inventory items assessed at 10% of just valuation.
13. available in Cook County.
14. phased; fully exempt 1984.
15. 10-yr partial prop. tax abatement in urban areas.
16. finished goods destined out of state.
17. 50% of federal tax paid.
18. 5-yr abatement on land & equip.
19. tangible property taxed at 1.3% of half its cost; tax repealed for equip. bought after 1/1/77.
20. first $58,500 of assessed taxable value of pers. prop.
21. 10-yr exemption on IRB-financed property.
22. applies to goods stored in licensed warehouse, provided at least 35% of prior year sales were shipped out of state.
23. local level only.
24. capital improvements only.
25. includes R&D equip.
26. local option in redevelopment areas.
27. pollution equip. only.
28. detachable tools & equip. with useful life up to 1 yr.
29. 1% credit based on wages for first 3 yrs. to selected new industries.
30. all inventories reduced to 4% of market value.
31. no sale/use tax.
32. up to 10-yr credit under job incentive program.
33. credit equal to 4% of qualified capital invested in new equip./facilities with useful life of 4 yrs. or more.
34. personal property.
35. 1% preferential rate on new equip., max. $80/article.
36. new construction only.
37. credits to manufacturers & processors for prop. taxes paid on goods in process.
38. sale/use tax excluded on items used in industrial production & research.
39. tangible personal prop. excluded from local tax.
40. 7-yr annexation or deannexation exemption.
41. credit for sales tax paid on energy.

taxes and energy costs, and **Missouri** makes the top 10 for its taxes, but ranks in the bottom 20 in labor, energy costs, and capital resources. And, unless you run a gambling business, **Nevada** may be one of the hardest states to do business in: The state ranks in the bottom 20 in every category.

Missouri, in particular, demonstrates the difficulties in grading states on their relative business climates. INC. didn't consider transportation costs in its analysis, and that factor is one of Missouri's advantages. Its location in the hub of the country's transportation system is an extremely important factor for companies with heavy shipping requirements.

In order to compute rankings in six areas of doing business and to assign a grade to each of the 50 states, INC. programmed a computer to weigh and compare more than 50 factors, based on data from numerous sources. We weighted these factors to reflect their importance to small businesses in general. For example, the availability of venture capital is far more important to smaller enterprises than giant corporations, so INC. placed more emphasis on that factor in ranking the states for capital resources. Likewise, we de-emphasized the importance of unions in the work force, because they affect smaller businesses less relative to large ones.

In addition, INC. generalized the computer model to make sure that the results of our analysis would be meaningful to a wide range of small companies. Energy costs, though, were analyzed for a high-technology, light-manufacturing company. Therefore the energy rankings would be somewhat different if the costs had been calculated from the point of view of a retail or service business, and considerably different for a heavy industrial manufacturing business.

Generalizing factors for whole states was also a problem. Tax burdens, for instance, are not necessarily uniform throughout the whole state. Maryland and Michigan both have very high tax burdens, but some aggressive areas within both states offer substantial property-tax exemptions. And California presents a significant problem in analyzing energy costs, because the whole state spans East Coast latitudes ranging from Connecticut in the north to South Carolina in the south. The degree days required for both heating and cooling cover wide ranges between the northern and southern latitudes. In addition, California, Florida, and New York are difficult states for calculating statewide labor climates: In each, the unemployment rates are higher in the southern, urban areas than in the northern, rural areas.

Perhaps the most difficult obstacles to creating an objective and meaningful critique of the states' small business climates is the highly subjective nature of the decision about where to locate a business. Among people who study this sort of decision, the current thinking is that most start-up businesses are located where their founders live. If the entrepreneur does have the luxury of deciding where to locate, the decision is most often based on factors that affect his business directly: proximity to markets in the case of regional, distribution companies, for example. Or the decision is based purely on the owner's lifestyle.

But a state's business climate does become particularly important in the case of companies that, having reached the expansion stage, want to find a good location for a new plant or branch office. And, from the state government's point of view, the true measure of managing the business climate well comes from the performance of those small companies already in the state. Without successful small companies, no state can look for real growth.

This report was prepared by Kuldarshan Padda, an editorial intern and Harvard undergraduate, with the assistance of INC. *senior editor Bradford W. Ketchum, Jr.*

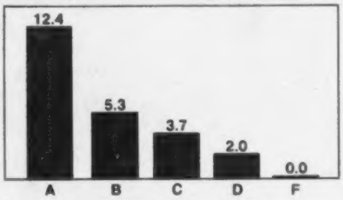
HIGH-PERFORMANCE COMPANIES LIVE IN HIGH-PERFORMANCE STATES

Not surprisingly, there is a direct correlation between the location of the country's fastest-growing, smaller companies and those states with the most positive climate for small business. When we matched up the location of the INC. 200 firms for the last three years and the states that earned an A in our analysis, we found that the top 20% of the states spawned 43% of the fast-growing companies.

From another angle, the relationship between business climate and the concentration of emerging companies becomes more clear. The average number of high-growth firms per state (adjusted) ranges from a high of 12.4 per A state to a low of 0 per F states.

We've adjusted the high-growth-companies-per-state formula to account for two anomalies: New Jersey and Missouri. New Jersey, a D state, has a high number of INC. 200 companies (19) for the last three years. But we discounted that because the business climate probably does less for emerging companies than the state's location in the bustling Northeast corridor. And Missouri is an anomaly: its one INC. 200 company, Billings, only recently moved there from Utah. Because most of the company's growth took place in Utah, we can't really give the credit to Missouri.

NUMBER OF INC. 200 COMPANIES (1979–81) PER STATE



HOW ABOUT PUERTO RICO AND THE VIRGIN ISLANDS?

Puerto Rico may be the perfect choice for companies who have reached the expansion stage, and are now deciding where to locate that new manufacturing plant. Over 30 INC. 200 companies would agree, that's how many have chosen the Puerto Rico option. Agressively pursuing the manufacturing industry (especially in high technology), this tropical island has put together a package of incentives that is hard to beat. Highlights of this package include a complete exemption from U.S. corporate income taxes along with a 90% exemption from Puerto Rican corporate income and property taxes. Another important benefit of operating in Puerto Rico is its low labor costs: less than half of the U.S. average. One of the many interesting programs that Puerto Rico offers is its twin plant concept. This involves sub-assembly work in foreign islands, elsewhere in the Caribbean, at dirt-cheap labor costs. The parts are then shipped back to Puerto Rico (U.S. tariff laws do not require taxation on re-imported parts), and final assembly work done.

These advantages led Puerto Rico located plants to achieve a profit-to-sales ratio of 22.6% compared to 5.7% of their counterparts on the mainland.

The major drawbacks of locating on the island are high shipping costs and management problems because of cultural shock. The high shipping cost can be turned into an advantage if you are interested in servicing the booming economies of Venezuela and Mexico. The culture shock is not really a problem anymore because close to 90% of all industrial plants in Puerto Rico are run by managers who are natives. This means there really isn't a need to send your own vice-president down there.

The Virgin Islands is attempting to lure manufacturing companies with a package of tax incentives consisting of a 100% exemption on real-property and gross-receipts taxes along with a similar exemption from excise taxes on plant-construction expenses. There are also subsidies on federal and local income taxes. Perhaps the major attractions are relatively low labor and shipping costs. The low labor cost is gained from operating in a depressed economy like that of the Virgin Islands. And shipping costs less because the islands are exempt from the Jones Act and do not have to ship their goods to the mainland via expensive American-flagged shipping. The problems in doing business in the islands include high operating costs due to expensive land, utilities, and other such factors. You also have to have a large inventory, since it takes a while to have items shipped from the mainland.

Mr. **Rangel**. Thank you. Mr. Ford.

Mr. **Ford**. I do not have any questions for the panel, but I would like to say it has been an issue that has been before this body and I guess dealing with industrial revenue bonds is something that we are going to have to at some point deal with.

I know you have offered your able leadership in this area and other members have expressed concerns as well as the administration in their position at the present time. I am sorry that I was late, but legislation I had to introduce on the House floor caused me to be late.

But Mr. Chairman, I have certainly enjoyed the testimony before the committee today and hope this committee will move to expedite the matter on this particular area.

Mr. **Rangel**. We thank you on behalf of the chairman and the full committee for taking time out to bring your thoughts before the committee.

Mr. **Unruh**. May I say one quick thing apropos to the politics of the whole range of tax exempt financing.

What happens in my State is that a legislator from a rural area will come in and introduce legislation asking for agricultural development bonds. Then a legislator from a distressed economic area will come in asking for a particular kind of bond. Somebody else will come in with pollution control—and I sat here throughout your hearing this morning and admired your patience, Mr. Chairman.

But there is no counterbalance anywhere to any of this. As this legislation progresses through the halls of the State legislatures around here or through the city councils or whatever they are, everybody has a little piece of the action. There is no such thing as a generalist in the field. Nobody comes in and opposes them because it is all out there. The grab bag is wide open. All of the time.

I think what you need to do is to build in some kind of a system, that is the reason I suggest some kind of a cap for each State, to make these people scramble for priorities. To make somebody at the State level set up a system of priorities and say we are not going to use bonds for hamburger chains but we will use bonds for building roads or sewers or whatever.

You know——

Mr. **Rangel**. We have placed a cap on. We have tried to look at this in our subcommittee every way we could. Some States have not even started to use them. They were concerned that other States have overabused them.

So it is difficult to talk——

Mr. **Unruh**. All of these people in front of you this morning, they have gone to the State and fought for a certain percentage there. That is the problem there. The grab bag is endless at this point until it runs the rates up as they have been recently, 14, 15 percent for tax-exempt financing.

There is no built-in opposition. I think you need to do that, have everybody get in and fight for a portion of it rather than feeling it is an endless open grab bag that everybody can stick their hands into as deeply as possible.

Mr. **Rogowski**. I would like to differ just slightly, he who gets there firstest will get the mostest, there could be a problem with that.

I think there will be a lining up in the doorstep of the various governmental entities on January 1 or 2 and there could be a legitimate need later in the year which might be of more benefit to the community and it would be too late. I would disagree with that.

Mr. **Johnston**. I agree. I think the small businesses will not be equipped to compete for local help, let alone compete on a statewide level. So I do not think that is a very good idea.

Mr. **Rangel**. We may have regional problems as well. In our system we go across the board. But if you took care of your political business sometime ago, we would not have this problem here today, right?

Mr. **Unruh**. For 7 years I have been trying to get a California Debt Advisory Commission. I finally got the legislature to pass it this year. So I think we are beginning to try.

Mr. **Stewart**. With all due respect, I was raised in the State of New York, which has plenty of problems with profligate legislators as you know. I cannot recall if Federal Government has ever been much help in teaching self-discipline to anybody. I think you are on the weakest grounds possible if you try to use the restriction on a general instrument of credit provision like the industrial revenue bonds as a way of providing equality of access among 50 States, and 4,000 labor market areas.

You ought to do just what you are doing, come up with reasonable litigations based on overall public policy concerns. You limit the use of the public's credit to things that legitimately deserve it. And on the basis of need, I have no doubt about it. Small business in terms of its other limitations and its other services to the economy, has to be at the head of the line.

Mr. **Rangel**. Thank you, Mr. Stewart.

Mr. **Ford**. Can I pose one question. I know your statement and I would like the other witnesses to comment. You talk about alternative ideas. I think you mentioned something about limiting the bonds to the urban enterprise zones as well as the economically distressed areas.

You know, since you were talking on this a minute ago, can I get the other members of the panel to respond to limiting these IDB's to those two areas?

Mr. **Rogowski**. I would like to put my voice in if I can. I have been personally always interested in having industrial revenue bonds for industrial facilities because I think originally when industrial development bond financing was created, it was to increase productivity, to create jobs, not necessarily commercial jobs or other jobs, but industrial jobs which would increase productivity and meet foreign competition.

And our committee has not taken a stand per se against commercial uses but we recognize that the Oversight Subcommittee has taken a fairly strong stand against certain uses and we believe that there is benefit for having commercial, but say in a targeted area, pocket of poverty, urban development action grant, because we recognize and we have wrestled with it in our own committee, that in many instances commercial jobs will give more jobs, dollar for dollar than industrial. I do not think any of us that only use them for industrial facilities will argue with that. I do not think that was the original intent, however. I think as was mentioned in the panel, I think two previous panels ago, maybe a Marriott Hotel in a distressed area should be allowed to do IDB financing because I am also familiar with hotel chains, and there are a lot of employees that are in need of jobs that get jobs because of hotels going up.

And I think that there is need for it but I think that in order to keep a limit as I think that Congress is expecting there to be a limit, the limit should be for industrial use, but in certain areas where we do need tremendous increase in productivity to rebuild areas, we should allow them in commercial areas.

Mr. Rangel. Thank you. I understand that one of the distinguished members of our committee would like to formally welcome Mr. Unruh here, Mr. Rousselot?

Mr. Rousselot. Thank you, Mr. Chairman.

Mr. Treasurer, it is nice to see you here from the great State of California. I hope our weather is better out there than it is here today. I know that you suggested some kind of a cap in your testimony.

How do you suppose we do that?

Mr. Unruh. I think the Treasury should make a determination based upon Congress recommendation or validation or whatever action, as to what Treasury can reasonably afford insofar as the loss of revenue is concerned. If that is $50 billion worth of tax-exempt financing throughout the year, then the State of California, based upon size, needs, or whatever other formula Congress should devise, would be entitled to 10 percent of that, or $5 billion.

Therefore you build in competition in this market which I said a moment ago is lacking. When you come in with a proposal in California, in 1980 our legislature created seven new authorities in 1 year. There are about 10 more kicking around now.

One of the responses to our utility rate increases has been to use more tax-exempt financing. At that point you build in opposition to these things. I think on that basis that reasonable men and women will weed out—for example in the IDB program, what we are getting now is one company that we reviewed an IDB issue for a few months ago. This was PIE, a huge national concern which really does not need that. But they want to build the terminals now.

Somewhere there has to be a limitation. I do not know that anybody in their wisdom can write all of their limitations correctly. I think let them all scramble for a portion of it. Mostly things will come out in the right way.

Mr. Rousselot. So then if your suggestion is that we write into the law some kind of an allocation, would each State then decide how that would be allocated among themselves?

Mr. Unruh. I would think that would, in the spirit of the new Federalism, that that would be a duty which you could entrust to the States.

Mr. Rousselot. Yes?

Mr. Rogowski. Congressman, may I assume that just because we are sitting on the same panel that we don't have to be on the same side?

Mr. Rousselot. I think you are allowed the chance to disagree.

Mr. ROGOWSKI. Thank you. I would like to disagree with that statement. I would like proof to show that there is a substantial negative impact on the Treasury. We have submitted in the past through the Oversight Committee and to the House Ways and Means Committee two studies prepared back in 1980 and 1981, neither of which showed a negative impact on the Treasury as a result of use of IDB's. I think if there is going to be a cap it has to be done for a different reason, maybe because there are not enough buyers of bonds.

Someone may be damaged because they are all competing for the same dollars, but I personally do not know I don't believe there is a negative impact on the Treasury. I hope I am not naive, but I have read the reports of Dr. Ture and Roger Kormendi and Tom Nagle published in 1980 and 1981 respectively. It showed really it was just a wash or slight positive impact because of the increase in social security payroll taxes and stuff that rides on the coattail.

So, I would disagree with the committee.

Mr. UNRUH. That assumes this committee is wasting its time, doesn't it?

Mr. STEWART. No, I do not think so if I may. It is entirely proper for the Congress of the United States to set standards for the States about how Federal tax exemptions are to be used. To say for example, since small business is the place we have to look for jobs, we would like industrial revenue bonds to be used by small business. You can do that one of two ways. You can say nobody else may have access to it, or you can't take more than 80 percent of the credit if you are not a small business, or a dozen different variations.

But, I think this notion you are going to create a useful competition by putting a cap on it simply is not borne out by my own experience. There is competition in the marketplace reflected by rates and purchases of bonds. I would leave it there. I think when the Federal Government tries to play private market participant is when it makes the biggest mistakes it ever makes.

Small business is being crowded out in two ways. By large companies and by Government. The best use of IDB's is use by small business. If there is to be any restriction I think that is the only one I would impose. As to enterprise zones, so far as I am concerned, do more for them rather than less for others.

Mr. ROUSSELOT. Do any of you want to comment on the enterprise zones? I realize it is not directly related here except it is a current proposal. Will that work in your area?

Mr. JOHNSTON. I might comment from the perspective of the small business and pollution control. I think generally speaking, the idea of targeting for commercial projects, which I think was contained in Congressman Rangel's bill, would at first blush not really seem to affect the people I am purporting to speak for. However, you think about a dry cleaner. Is he a commercial business? He has solvents and so on that he now has to do some special things to control. I guess I think I pay enough to get my shirts laundered now. That would be an example. It may not be the only one, of the kind of business that could fall into the trap if you had a limitation that applied only to commercial projects.

Mr. UNRUH. I think my own feeling on that is expressed in my testimony. I think it is certainly worth looking at. It seems to me that the wild proliferation of tax-exempt financing has to have an end somewhere. Otherwise we are going to move totally completely to tax-exempt financing.

That is what we are doing with many of these issues right now. There may be some excuse for subsidizing tax-exempt bonds. A big company building a facility in an economically distressed area, for example. But there is no reason for giving them that financing through small issue IDB's to build the plant in an already prosperous area.

Mr. JOHNSTON. I would like to offer my personal belief or response that I really believe that the increased use in IDB's in the last few years is more an effect than a cause.

Mr. STEWART. Exactly.

Mr. JOHNSTON. It is an effect of a prolonged period of high interest rates.

Mr. STEWART. Absolutely.

Mr. JOHNSTON. It is the only thing that has been affordable for many businesses. I would also urge the committee to monitor the use of IDB's on a monthly basis. In my written testimony I mention that the IDB volume in January of this year was down 57 percent. I think some corrections are taking place in the marketplace, and I would just urge you to keep up on what is happening, rather than rely on information that is now a little bit out of date.

Mr. ROUSSELOT. Your suggestion is that we monitor every month?

Mr. JOHNSTON. I don't mean to—I don't know exactly how that works, Congressman.

Mr. ROUSSELOT. Not too well.

Mr. JOHNSTON. Perhaps your staff could——

Mr. ROUSSELOT. We have a tough time monitoring anything once a year.

Mr. JOHNSTON. Perhaps the staff of the committee could receive that information. It is published information by, for example, the Public Securities Association.

Mr. ROUSSELOT. By all States?

Mr. JOHNSTON. Yes.

Mr. ROGOWSKI. There are some States already, of course, that regulate. I know just recently I was involved in North Carolina, Alabama, and also Connecticut. You do have to go through fairly substantial filings. I know in North Carolina where I have three industrial facilities right now, it was a difficult task. I know that one company in warehousing wasn't allowed. It was only allowed for industrial purposes. I keep hating to challenge my colleague on the left here. But——

Mr. ROUSSELOT. He is a tough guy to challenge.

Mr. ROGOWSKI. I gather as much. I would take issue also with the statement that large companies should not be allowed to issue IDB's. All of us read the newspapers. Large companies are having just a heck of a time surviving, as small. I think large or small has nothing to do with it. I think the original intent of having IDB's for a small amount of money, now $10 million which we think is small, is not to allow any one large company to have an adverse effect on a community.

So, if a large company with $100 million, or $200 million IDB grant if it could have gotten such went in a community and shut down it could wipe out the whole community. That is the reason for the limitation.

We believe on the committee that $10 million is too low. We think $15 million is more reasonable because of inflation. But if Congress sees fit to leave it at $10 million, we think $10 million will allow 150 or 175 industrial jobs in a project in the community. In the community, I do not think that in the average community this would have an adverse impact if something should go wrong. But to say you have to be a small company to have it, and you can't be a large company, you are taking away the right from the community to pick a group of companies that they may want to have.

I firmly believe the States ought to regulate who should go into a community or State and there should be hearings in the local communities. I do not know where anybody else has issued revenue bonds but I have done this since 1965 and I can tell you I cannot recall a single exception where I have not called a meeting and not personally appeared or had someone appear for me and I have pled with the local community, shown how many jobs I am giving and what my payroll is going to be. I can also state in almost every instance my estimates have been conservative, and we have given more jobs. I have also stated earlier that I have created 4,500 jobs because of industrial revenue bonds. I have written to probably every member of the committee when it looks like things are getting hot over IDB's and have sent out a letter specifically to a Congressman pointing out what our company has done in that community, in that State, and what jobs we have created.

Mr. RANGEL. I think this panel has clearly demonstrated the problem that we face on the committee and in the Congress. Let me thank you for your contribution. If you have any further thoughts as you see us progressing, please feel free to call upon the committee because, seriously, we do what we hope is best, but you fellows are out there on the firing line and we appreciate your thoughts. The record will remain open until the end of this week if you have additional testimony you would like to submit.

All of your statements, for those who left from their prepared statements, will be entered into the record.

Mr. UNRUH. Thank you, Mr. Chairman.

Mr. ROGOWSKI. Thank you, Mr. Chairman.

Mr. JOHNSTON. Thank you, Mr. Chairman.

Mr. STEWART. Thank you, Mr. Chairman.

Mr. RANGEL. Thank you very much.

The last panel, Justus Martin, Jr., chairman and chief executive officer of the Robinson-Humphrey Co., Chip Morgan, director, industrial and community development, Delta Council for the Small IDB's. Mr. Warren Preeshl, vice president, Miller & Schroeder Municipals, Inc. I think Ms. Cincotta from the National People's Action won't be able to be with us.

The record will remain open if her representatives are here to submit for the record.

STATEMENT OF JUSTUS C. MARTIN, JR., CHAIRMAN AND CHIEF EXECUTIVE OFFICER, ROBINSON-HUMPHREY CO., INC., ATLANTA, GA.

Mr. MARTIN. Mr. Chairman, Members of the Committee, my name is Justus C. Martin, Jr. I am chairman, president, and chief executive officer of the Robinson-Humphrey Co., Inc., Atlanta, Ga., a major regional firm in the investment banking industry.

I am a member of the board of directors and the executive committee of the Securities Industry Association. I am also a member of the board of governors, New York Stock Exchange. My testimony this afternoon—and my written statement filed with the committee staff—are presented solely as the position of Robinson-Humphrey and do not purport to state or otherwise represent the viewpoint of any other organization of which I am a member.

First, I would like to thank the committee for this opportunity to appear before you today. I express particular appreciation to your colleague and my Congressman, Hon. Wyche Fowler, Jr., for inviting me to present to the committee our position and certain recommendations on "small issue" industrial development bond financing, which I shall refer to in my remarks as "IDB Financing."

Let me volunteer to the committee that since 1973, Robinson-Humphrey has been engaged in, among its other investment banking activities, the origination and underwriting of IDB financings. However, in our most recent fiscal year ended December 31, 1981, revenues generated from IDB financing represented approximately 1.3 percent of Robinson-Humphrey's total revenue and accounted for less than 5 percent of our profit before income taxes.

Last week, unemployment in America was reported at 9 percent. Interest rates remain near their historic highs, with some economists predicting further rises in interest rates later this year. There exists a critical need for American industry to again become competitive with foreign manufacturers.

Therefore, we respectfully urge the committee to preserve IDB financing, which has been, and continues to be, a valuable economic development resource for local communities, and a meaningful incentive to capital spending by American private enterprise—from the major, nationally known corporations down to the hometown proprietorships. Both create jobs.

Were it not for the well-publicized "abuses" of IDB financing, which have received national media attention. I probably would not be testifying before you this afternoon. We concur whole-heartedly with the U.S. Treasury Department, the Municipal Finance Officers Association and other public officials like Mr. Unruh that the exemption from Federal income taxation historically granted to the interest earned on the debt obligations of State and local governments was never intended to allow every capital spending project—public and private—to be financed through the issuance of tax-exempt securities.

During the most recent 5 years, there has been a veritable explosion in the volume of IDB's issued to finance commercial projects. We, and other supporters of IDB financing for manufacturing and industrial purposes, call these bonds "burger bonds." "Burger bonds" have clearly distorted the original purpose of IDB issuance, that is, to provide an incentive and financing assistance to the creating of industrial and manufacturing employment—the "core" jobs in any local economy. "Burger bonds" have also contributed significantly to a market-disruptive increase in IDB volume.

In the Congressional Budget Office study on small issue industrial development revenue bonds, revision of September 1981, data for fiscal year 1979 identified the States of Pennsylvania, Ohio, New Jersey, and Minnesota as accounting for approximately 45 percent of nationwide IDB financing volume. Of that 45 percent, approximately 54 percent represented commercial-purpose projects, with industrial/manufacturing and warehousing/distribution projects at approximately 32 percent and 14 percent, respectively.

Given the dramatic rise in interest rates that began in the fourth quarter of calendar 1979, which has focused increasing attention upon the borrowing advantage of IDB financing, I am confident that more recent data on IDB financing will confirm that the issuance of IDB's for commercial purposes has accelerated even beyond the 1979 trend. We respectfully submit that the time has come for Congress to draw the line.

Following hearings in April 1981, your oversight subcommittee, among other provisions, recommended that IDB issuance for commercial purposes be restricted to "economically distressed areas." The recommendations of your oversight subcommittee were essentially embodied in H.R. 4420, introduced September 9, 1981, by Hon. Charles B. Rangel and cosponsored by Hon. Sam M. Gibbons and Hon. W. Henson Moore.

We fully support a "targeting" of IDB issuance for commercial purposes to such "economically distressed areas," believing that such a restriction will restore IDB issuance to its originally intended purpose and substantially reduce IDB financing volume, while, at the same time, providing economically distressed areas with an additional financing assistance incentive.

We hope that the committee will reject legislative initiatives by the Treasury to restrict, by arbitrary criteria, the availability of IDB financing to small- and medium-sized companies. A job created by a major corporation is just as economically valuable—and perhaps more stable—as a job created by a small- or medium-sized company. Also, facilities of major corporations are more likely to attract related support and service businesses.

Mr. Chairman, since 1936, the issuance of IDB's has helped create core jobs in this country. IDB issuance is now authorized in 48 of our 50 States. Again, we urge the committee to preserve small issue IDB financing. Such preservation, we believe, can be principally accomplished by the targeting of commercial purpose IDB issuance and other measures in the Rangel bill, including mandatory reporting by States of IDB issuance, the holding of public hearings prior to IDB issuance and the conducting by the Treasury Department of a comprehensive study on IDB financing.

I welcome any questions or comments the committee or your staff may have concerning my testimony. Thank you for your kind attention and consideration.

[The prepared statement follows:]

STATEMENT OF JUSTUS C. MARTIN, JR., CHAIRMAN, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, THE ROBINSON-HUMPHREY CO., INC., ATLANTA, GA.

Mr. Chairman, Members of the Committee, Ladies and Gentlemen:

My name is Justus C. Martin, Jr. I am Chairman, President and Chief Executive Officer of The Robinson-Humphrey Company, Inc. ("Robinson-Humphrey"), Atlanta, Georgia, a major regional firm in the investment securities industry. I am a member of the Board of Directors and the Executive Committee of the Securities Industry Association. I am also a member of the Board of Governors, New York Stock Exchange. My statement is presented solely as the position of Robinson-Humphrey and does not purport to state or otherwise represent the viewpoint of any other organization of which I am a member.

First, I would like to thank the Committee for this opportunity to appear before you today. I express particular appreciation to your colleague and my Congressman, Honorable Wyche Fowler, Jr., for inviting me to present to the Committee our position and certain recommendations on "small issue" industrial development bond financing ("IDB financing"). In the interest of full disclosure, let me state that for the past nine years, Robinson-Humphrey has been engaged in, among its other investment banking activities, the origination and underwriting of IDB financing; however, in our most recent fiscal year ended December 31, 1981, revenues generated from IDB financing represented approximately 1.3% of Robinson-Humphrey's total revenue and accounted for less than 5% of our profit before income taxes.

With unemployment and interest rates at or near historic highs, and recognizing the critical need of American industry to again become competitive with foreign manufacturers, we respectfully urge the Committee to preserve IDB financing, which has been, and continues to be, a valuable and important economic development resource for local communities, and a meaningful incentive to capital spending by American private enterprise. We also support, as recommended last year by your Oversight Subcommittee, correcting the abuses of IDB financing that have proliferated during the most recent five years. These abuses have not only distorted the original purpose of IDB issuance, i.e., to provide an incentive and financing assistance to the creation of industrial and manufacturing employment, but have contributed significantly to a disruptive increase in IDB volume. We concur with the position that the exemption from Federal income taxation historically granted to interest income earned on the debt obligations of State and local governments was never intended to allow every capital spending project -- public and private -- to be financed through the issuance of tax-exempt securities. The time has come for Congress to draw the line.

Therefore, we support limiting the availability of IDB financing to:

(i) industrial, manufacturing and processing facilities;

(ii) related warehousing and distribution operations;

(iii) health care facilities, both non-profit and for-profit; and

(iv) commercial facilities targeted to economically distressed areas.

Beginning with the 1936 introduction of the State of Mississippi's Balance Agriculture with Industry Program, IDB issuance has evolved and matured from providing a limited number of states with a competitive advantage in attracting new industry into a nationwide (48 states) financing vehicle. Today, the principal purpose and value of IDB financing is to encourage and facilitate expenditures for new plant and equipment by reducing the cost, through lower interest rates, of funding such capital expenditures. For example, in current bond markets, the difference in interest rates between IDB and conventional financing is not less than 3%. On a $5,000,000 financing for a new or expanding facility, financed by IDBs over a period averaging 10 years, the pretax interest saving would be $1,500,000. As has been well documented, increased capital spending translates directly into additional employment opportunities.

Therefore, we strongly oppose current legislative proposals sponsored by the United States Department of the Treasury ("Treasury") which, in our opinion, would substantially eliminate the attractiveness and availability of IDB financing to a significant number of prospective users. Forcing such prospective users to choose between a cost effective financing method (IDB issuance) and the employment of an accelerated cost recovery system ("ACRS") denies the need for, and ignores the differing benefits of, both capital spending incentives. Further, to exclude the so-called "Fortune 1000" companies from using IDB financing would illogically discriminate, on the basis of corporate size, between prospective users, and would be counter-productive to the efforts of local communities to increase employment by attracting new industry. A job created by a major corporation is just as economically valuable as one generated by a small or medium-sized company. Also, facilities of major corporations are more likely to attract support and service businesses.

We further submit that the oft-publicized estimates of IDB-related Federal "revenue loss", at which Treasury's proposals are aimed, have been exaggerated. Such estimates fail to take into account that reducing interest expense increases corporate earnings subject to Federal income taxation. Also, we firmly believe that IDB financing is helping put people to work in this country. The estimates of Federal cost attributable to each unemployed person are staggering -- and well-known to the Committee. We respectfully submit that the focus of the Committee upon IDB financing can be directed more productively toward correcting the abuses of IDB financing rather than by considering the elimination of a proven economic development, job creation resource.

Toward that focus, we are prepared, with the major exception of the proposed December 31, 1983 termination of IDB financing, to support, in principle, the recommendations of the Oversight Subcommittee, as contained in H.R. 4420 (the "Rangel Bill"), introduced September 9, 1981 by Honorable Charles B. Rangel and co-sponsored by Honorable Sam M. Gibbons and Honorable W. Henson Moore . We shall communicate to the offices of Honorable Ed Jenkins and Honorable Wyche Fowler, Jr. suggested changes to certain of the provisions as now appearing in the Rangel Bill.

We also oppose that provision in the Rangel Bill which would prohibit using IDB financing in connection with industrial facilities moving from one State to another. Such prohibition would represent, in our opinion, an unwarranted deterrent to a corporation's ability to decide independently where such facilities can most profitably be operated. Such a relocation, for a variety of economic reasons, may have become necessary or unavoidable; and further, would obviously increase employment and economic activity at the new location.

To facilitate the utilization of IDB issuance as an effective financing vehicle, we also support (i) eliminating research and development costs from the definition of "included" capital expenditures, and (ii) repealing or otherwise invalidating Internal Revenue Service Revenue Ruling 81-216. The effect of that Ruling has been to block arbitrarily composite offerings of IDB issues. Composite offerings are inherently time and cost efficient to users of IDB financing. The findings set forth in Revenue Ruling 81-216 contradict the intent of imposing, on an individual project basis, the $10,000,000 limitation upon capital expenditures already proscribed by Section 103 (b)(6)(D) of the United States Internal Revenue Code of 1954, as amended (the "Code"); and further, Revenue Ruling 81-216 represents an attempt to legislate by administrative fiat rather than through Congressionally-enacted changes to the Code.

In conclusion, let me emphasize that our principal recommendations to the Committee are that IDB financing be preserved for industrial and manufacturing purposes, and that by "targeting" commercial purpose IDB use to economically distressed areas, the abuses of IDB financing can be substantially eliminated. We welcome any questions or comments the Committee or your Staff may have concerning our Statement. Thank you for your kind attention and consideration.

Mr. RANGEL. Thank you, Mr. Martin.

Chip Morgan.

STATEMENT OF CHIP MORGAN, DIRECTOR, INDUSTRIAL AND COMMUNITY DEVELOPMENT, DELTA COUNCIL, ON BEHALF OF THE AD HOC COMMITTEE FOR SMALL ISSUE DEVELOPMENT BONDS, AND THE SOUTHERN INDUSTRIAL DEVELOPMENT COUNCIL

Mr. MORGAN. Thank you, Mr. Chairman and committee members for allowing the Southern Industrial Development Council to have the opportunity to be represented on this panel.

The Southern Industrial Development Council represents more than 1,450 development organizations ranging from the size of local chambers of commerce in rural areas to large metropolitan or statewide economic development efforts in a 17-State region.

We do not support the continued use of tax-exempt industrial revenue bonds for any purposes other than manufacturing, processing, and related warehouse distribution uses. We hope that industrial revenue bond laws will be revised in order to eliminate all other uses of IRB's.

Our State of Mississippi, which I am most familiar with, exercises these restrictions on industrial revenue bonds, and it has been used quite successfully. I refer to a letter in this testimony of response which Congressman Sam Gibbons offered to Congressman G. B. Montgomery regarding his assessment of the IRB programs in the State of Mississippi which has similar programs throughout another nine States in the United States restricting industrial revenue bonds to manufacturing related purposes.

Because of a lack of adequate information on a national scale, due to the lack of reporting, may I refer to statistical data which we have compiled on the effect of IRB financing in our own State?

Obviously, this would be applicable in every State that uses industrial revenue financing for manufacturing operations exclusively. Our data shows that the Federal Treasury revenue losses which resulted from the tax-exempt feature of IRB's for manufacturing operations in Mississippi was $29.5 million. However, as a result of the employment alone provided by these specific manufacturing operations in that same State, approximately $32 million was paid into the Federal Treasury as a result of these 26,000 manufacturing jobs that were provided by industrial revenue bond financed operations.

This data does not make any reference to the estimated 1.9 additional jobs provided in our State as a result of expanded manufacturing operations which require support services and trade areas.

Also we would like to point out that we could not identify comparable benefits which would accrue to either local governments or the Federal Treasury as a result of commercial and other uses of industrial revenue bonds.

With reference to the Treasury position creating a capital expenditure limit and provisions for requiring a choice between a CRS and industrial revenue bonds, the Southern Industrial Development Council is opposed to these positions.

Instead, we advocate restricting IRB's by purpose, rather than by arbitrarily setting a capital expenditure limit or providing a choice for companies to utilize for industrial revenue bonds or a CRS. The capital expenditure limit in our opinion is most dangerous and totally avoids the question of purpose. We do not feel like big is bad, and we don't feel that industry should be limited in the use of IRB's because of their size.

At a time when national focus is on revenue enhancement, coupled with the economic recovery that we are facing, it would appear to us counterproductive to eliminate IRB's which assist in manufacturing employment and in turn actually pay their own way according to our statistical data.

However, without eliminating or restricting the use of IDB's for purposes other than manufacturing and manufacturing related projects, we do not feel that the U.S. Government would realize a significant reduction in the revenues lost as a result of these so-called abuses that were pointed out through your hearings, Mr. Chairman.

In summary, we would like to say that industrial revenue bonds do pay their own way and actually accrue dividends toward economic recovery when used for manufacturing and manufacturing related purposes exclusively.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF CHIP MORGAN, DIRECTOR, INDUSTRIAL AND COMMUNITY DEVELOPMENT DEPARTMENT, DELTA COUNCIL

Mr. Chairman and Members of the Committee:

My name is Chip Morgan. I am Director of the Industrial and Community Development Department of Delta Council, an economic development organization supported by the agricultural, business and professional leadership of Northwest Mississippi. Almost 18 months ago, with quite a bit of attention being directed toward the abuses of the industrial revenue bond program, our organization, acting on the advice of Congressman Jamie Whitten, began contacting similar economic development organizations throughout the Nation in order to study the serious situation surrounding the abuses of industrial revenue bonds. Today, I appear before you representing the Southern Industrial Development Council, consisting of more than 1,450 industrial development specialists from a 17-state area who direct the local efforts for attracting new job opportunities for their respective municipality, county, state or other political subdivisions. In our opinion, and later to be confirmed by the proceedings of hearings held by your Oversight Subcommittee, industrial revenue bonds would be jeopardized as a viable industrial development tool if local industrial developers did not offer a clear and practical course of action for curbing the so-called "abuses" of industrial revenue bonds.

In 1936, Mississippi was the pioneer in establishing industrial revenue bond financing for new and expanding manufacturing operations. Since that time, 47 other states have begun to allow industrial revenue bonds to be issued for projects that presumably serve a public purpose that would not otherwise be served without tax-exempt financing. Since industrial revenue tax-exempt bond financing is guaranteed solely by the applicant's financial ability to pay back the bonded indebtedness and the financial integrity of the participating applicant, a large number of public bodies and locally authorized development authorities have found it appropriate to issue tax-exempt industrial revenue bonds for a high percentage of "projects" which were never intended to become eligible when Congress established this industrial development inducement.

During recent months, industrial development organizations representing the local business and professional leadership of virtually every part of the United States have reviewed the various proposals aimed at revising the industrial revenue bond program. We feel that the real issue confronting Congressional leaders, the Treasury Department, and the Administration with regards to industrial revenue bonds was studied thoroughly and pointed out in numerous ways throughout the hearings process which was initiated by this Committee on April 8, 9, and 10, 1981. After reviewing the Congressional Budget Office report and the text of the hearings on this issue, we have not found a single Congressman or any staff person for the Congressional Budget Office who claims that manufacturing projects could be considered an abuse of the industrial revenue bond program. On the other hand, because of the political implications surrounding the elimination of industrial revenue bond issues for purposes other than manufacturing and manufacturing-related projects, most of the proposals for revising industrial revenue bonds have avoided addressing the one alternative approach which would be extremely unpopular among the special interest groups, but nevertheless, an approach that would bring integrity to the program and restore it to its original purpose. The special interest groups represent a large part of the increase in the issues that were studied through the C.B.O. report and the Congressional hearings. In our opinion, industrial revenue bonds should be restricted to manufacturing, processing and related warehouse distribution operations exclusively, as is practiced in almost 10 states at this time. As a policy, my State of Mississippi exercises these restrictions and, quoting Congressman Sam Gibbons in a letter to Congressman G. V. Montgomery, (Exhibit I) "....if everybody operated in the exemplary manner that Mississippi operates, we would not have any trouble with the industrial revenue bonds."

The Southern Industrial Development Council recognizes that long-term tax-exempt bond issues, such as industrial revenue bonds, often influence an investment decision which would otherwise not be made. On the other hand, jobs in the commerical and retail sector of our economy will customarily be made based on an available market and not because a financial inducement is needed. The American Economic Development Council, made up of economic development organizations from every state in the Nation states that there is a "rapid escalation of revenue bond issues to finance massage parlors, fast-food joints, and other marginal commercial projects...also big retail chains are using tax-exempt bonds to locate in suburban shopping centers, thus using local financing authorities to drain business away from downtown retailers."

While the original provisions which established tax-exempt financing did not stipulate that commercial projects should be restricted from the use of this tax-exempt industrial financing tool, the common and assumed name of "industrial revenue bond law" clearly indicates the intended use for this tax-exempt instrument to help create jobs in the manufacturing sector of the economy. The manufacturing sector has accounted for a tremendous economic transfusion to every area of this country where these tax-exempt instruments were utilized.

Because of a lack of information regarding this program on a National scale, I would like to make reference to the economic influence which industrial revenue bonds have had on our State of Mississippi in recent years as an example to you of how this program can be utilized effectively while still maintaining some economic balance. As a cost-benefit analysis for the Federal Treasury, Mississippi authorized and issued $1.5 billion in industrial revenue bonds during the six-year span between January, 1976 and February, 1982. In an analysis of the locations of those manufacturing companies which utilized industrial revenue bonds, 78 located in very marginal situations.

Many of these companies located in rural areas of Mississippi which could not possibly offer any local assistance or conventional financing to a manufacturing operation. If industrial revenue bonds had not been available, the Mississippi Research and Development Center states that "these companies would either have expanded or located elsewhere or possibly even eliminated their project entirely. These 78 companies are currently employing over 12,000 persons in manufacturing jobs."

Reflecting on the study which was initiated by the Mississippi Research and Development Center regarding IRB's cost to the Federal Treasury, in Mississippi during 1981, the tax-exempt feature of industrial revenue bonds cost the Federal Treasury $29.5 million in tax revenues. This estimate is based on the assumption that owners of the bonds are in a 50% tax-rate bracket for federal income tax purposes. It also assumes an adjustment to the amount of corporate income taxes paid due to a higher pre-tax profit due to reduced interest rates made possible in IRB financing. I offer you Exhibit II to demonstrate clearly that although industrial revenue bonds administered for manufacturing purposes serve as a cost to the Federal Treasury in the amount of $29.5 million during 1981, the estimated federal taxes paid by manufacturing employees of industrial revenue bond financed companies totaled approximately $32 million during that same period. This statistic is relative and applicable to industrial revenue bonds issued for manufactuirng purposes in every state of our Nation. The study also reveals that for each manufacturing job generated through an industrial revenue bond financed company, Mississippi gains an additional 1.9 jobs in support services and trades which are required as a result of a manufacturing location.

In contrast to the tremendous dividends accrued to local governments and the Federal Treasury through an expanded tax base as well as the benefits accruing to the Federal Treasury through federal income tax revenues, jobs in the commercial and retail sector of our economy do not stimulate the same reaction for economic growth and prosperity. It is our belief that industrial revenue bonds were created by the Congress of the United States as a financial inducement to encourage industry to expand and create jobs resulting in an economic stimulus to every level of government. The continued use of industrial revenue bonds for purposes other than manufacturing, processing and related warehouse distribution has jeopardized the integrity of this program in the eyes of a large number of Congressional leaders, the Administration and a public that is vitally concerned about the prospects of economic recovery. During a time when our focus as a Country is directed on revenue enhancement measures and economic recovery, it would appear that it would be counter-productive to eliminate or restrict the use of industrial revenue bonds for manufacturing-related purposes that assist in the creation of thousands of job opportunities annually. We fully endorse the efforts of the House Ways and Means Committee to study possible alternatives for revising the industrial revenue bond programs; however, we would urge you to allow this industrial financing tool to continue to meet its original purpose and accomplish the goal of assisting local communities in their efforts to attract new and expanding job opportunities.

SAM M. GIBBONS
7TH DISTRICT, FLORIDA

PLEASE RESPOND TO:
☐ HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515
TELEPHONE, (202) 225-3376

☐ 500 ZACK STREET
ROOM 515
TAMPA, FLORIDA 33602
TELEPHONE, (813) 228-2101

MAR 7 1981

WAYS AND MEA
COMMITTEE

SUBCOMMITTEES:
TRADE
OVERSIGHT
, CHAIRMAN

MARGO O'CONNOI
DISTRICT OFFICE MANA
TAMPA

Congress of the United States
House of Representatives
Washington, D.C. 20515

March 6, 1981

The Honorable Gillespie V. Montgomery
2367 Rayburn House Office Building

INSIDE MAIL

Dear Sonny:

I appreciate your sending me that material, and if everybody operated in the exemplary manner that Mississippi operates, we would not have any trouble with the Industrial Revenue Bonds (IDBs). But, unfortunately, some of the States have gone wild and have financed hamburger fast-food outlets, K-Mart stores to attempt to compete with other stores that must pay taxes, and even a topless bar, which I am sure you wouldn't approve of, Sonny.

The attached information may be useful to you in responding to the DELTA Council.

Sincerely,

Sam

Sam M. Gibbons
United States Congressman

SMG:f
enc.

STATISTICS RELATING TO INDUSTRIAL REVENUE BONDS ISSUED IN MISSISSIPPI FROM JANUARY 1, 1976, TO FEBRUARY 1, 1982

Total number of bond issues authorized	221
Total amount authorized	$3,244,945,000
Total amount issued	1,532,485,000
Interest paid on Mississippi IRBS in 1981	69,059,135
Total manufacturing (SICs 2011 - 3999) Employment of IRB finance companies	26,710
Estimate of federal taxes paid by manufacturing employees of IRB financed companies	31,945,160
Number of manufacturing projects in process with IRBs authorized but not yet issued	54
Number of companies with $20 million or more of IRBs issued in past 6 years	12
Number of manufacturing projects with IRB financing located in counties with serious industrial readiness deficiencies	78
Number employed by IRB financed companies in counties with serious industrial readiness deficiencies	12,692

SOURCES: Mississippi Research and Development Center, March, 1982.

Internal Revenue Service, Statistics of Income - Individual Income Tax Returns, February, 1981.

1982 Mississippi Manufacturers Directory, December, 1981.

Unpublished records of the Mississippi Department of Economic Development.

Mr. **Rangel**. Thank you, Mr. Morgan.

Mr. Preeshl.

STATEMENT OF F. WARREN PREESHL, VICE PRESIDENT, MILLER & SCHROEDER MUNICIPALS, INC., MINNEAPOLIS, MINN.

Mr. **Preeshl**. Thank you, Mr. Chairman.

It is a pleasure to be here and participate in this discussion. My name is Warren Preeshl, I am with Miller & Schroeder Municipals which is located primarily in Minneapolis, Minn., with a major office in Solana Beach, a suburb of San Diego, Calif.

We have about 100 employees. We sell approximately 500 million dollars' worth of bonds a year of which perhaps 20 percent are industrial revenue bonds, 40 percent are hospital, nonprofit corporation bonds, and the other 40 percent are miscellaneous revenue G.O. and tax increment bonds.

I would like to summarize my statement in which we have several recommendations, and then comment on a number of things. The gist of our experience has been that the use of industrial revenue bonds for both industrial and commercial purposes produces jobs and tax base that would otherwise not be produced. We think it is important in these times that every inducement be given to companies to expand their operation and hire more people, and I see company after company that is worried about the high interest rates. If there is a reasonable opportunity to moderate that interest rate, they will expand, otherwise, they won't.

We do not believe that the use of industrial revenue bonds deprives the Federal Government of revenues. It is important to recognize that the first effect of a reduced interest rate from the use of industrial revenue bonds is to increase the income taxes that the company pays.

In other words, 46 percent of the interest rate savings goes right to the Federal Government directly. The other side of the coin, who buys, if they were to buy, taxable bonds is becoming more and more clear. The purchasers of much of the taxable debt in this country are those who are exempt from the income tax, whether they are IRA investors, Keogh investors, pension funds, profit-sharing funds, and so forth.

So, if the interest rate is reduced by use of an industrial revenue bond, the Federal Government directly benefits. There is no assurance that denying tax-exempt financing and putting such financing into taxable debt would increase the tax revenues of the Federal Government at all.

Our particular recommendations—and this is in line with our thought that industrial revenue bonds are a useful tool for capital formation—is that the bonding limit be raised to $10 million. That is not a capital expenditure limitation, but a direct bond limit without regard to capital expenditures. This recommendation cuts through particularly the research and development problems which have curtailed the use of industrial revenue bonds in our area for expansion, because we are a high technology State. Counting capital expenditures for research and development make it difficult for some companies to expand.

We do agree that there are certain things that should not be financed, and a number of bills have addressed that.

In Minnesota we found that one of the most useful devices for limiting certain commercial uses is the public hearing concept. About 4 years ago the State law was amended so that there is a requirement for a 15-day notice, of a public hearing. All information is on file for anybody who wants to come in and talk about it. The public hearing has been very helpful in guiding municipal officials in approving certain bonds.

We think that ACRS should be allowed with industrial revenue bonds. Again, if we are going to have companies expanding their facilities and creating jobs, hiring people, they need every incentive possible.

The "umbrella financing" technique is a useful device, particularly applicable to small companies because it allows efficient marketing of bonds.

We would suggest, and we do this in Minnesota, that every city report to a State agency the amount and purpose of all industrial revenue bonds that have been issued, and further that each State then report to the Secretary of the Treasury. At the moment, as you know, any issue of bonds in excess of $1 million is reported to IRS. But I have hunch that that information is hard to garner. It would be simpler to have 50 States reporting to the Treasury.

This concludes my summary. If there are any questions that any of us on the panel can answer, I am sure we would be pleased to do so. Thank you for your time.

[The prepared statement and additional information follows:]

STATEMENT OF F. WARREN PREESHL, VICE PRESIDENT, MILLER & SCHROEDER MUNICIPALS, INC.

My name is F. Warren Preeshl and I am a Vice President of Miller & Schroeder Municipals, Inc. Miller & Schroeder is an investment banking firm specializing exclusively in tax-exempt bonds issued by cities, counties, states, etc., to finance a wide range of public improvements such as schools, city halls, water, sewer, streets, etc., as well as other improvements, such as airports, hospitals, industrial revenue bond financed facilities, single and multifamily mortgage bonds, etc. Based on a recent PSA report, Miller & Schroeder, in the category "revenue bonds" (in which we particularly specialize), ranked 16th in the national underwriting industry ratings. We have offices in Bloomington, Minneapolis and St. Paul, Minnesota; Solana Beach, California (a suburb of San Diego); Chicago, Illinois; and Naples, Florida. Personally, I have been in the municipal bond business in Minnesota since 1950, being active in financing projects generally throughout the United States, but specializing particularly in the upper midwest, southeastern United States and the west coast.

Miller & Schroeder's annual origination of municipal bonds is in excess of $500,000,000. We have about 100 employees, have sold bonds to about 40,000 investors and are licensed to offer bonds in 25 states.

In considering our annual volume, we like to relate it insofar as revenue bonds are concerned, to new job creation. The number of jobs created by a revenue bond project varies with the capital cost per job, and ranges from perhaps one job per $25,000 to $100,000 of investment.

Using $100,000 per job, our annual sales indicates an annual job creation of 5,000, a record of which we are very proud.

In our underwriting for the Port Authority of the City of Saint Paul, the job creation in 1981 was 3,273, derived from new plant investment of $125,492,000 ($38,342 per job).

I. Recommendations

Miller & Schroeder has been particularly active in underwriting two types of financing being considered by the Committee; one type is industrial development bonds and the other type is non-profit hospital bonds.

After considerable thought, and as developed in further detail below, our suggestions to the Committee are as follows:

1. Eliminate the $1,000,000/$10,000,000 distinction and allow an issue of up to $10,000,000 without any capital expenditure limitation. This change particularly benefits high technology companies with their large past and large anticipated research and development expenditures.
2. Prohibit the use of "commercial" IDB's for certain facilities, as has been previously suggested by Representative Gephardt.
3. Continue to allow ACRS in conjunction with IDB's. As a nation, we need all incentives possible so as to encourage capital formation and job creation.
4. Permit "umbrella" financing, within the above limits, so that small companies with small individual needs can efficiently have access to the bond market.
5. Continue the exemption for non-profit hospitals, but with the continued requirement of a certificate of need.
6. Require a public hearing by the issuer. We have done this for years in Minnesota, and it works well.
7. Require a reporting of all IDB's to a state agency, with 50 state reports going annually to the Secretary of Treasury.

II. General Discussion of Administration's Proposals

We, like everyone else in the municipal finance industry, are concerned with the high level of interest rates and the continued availability of tax-exempt financing to local and state government in areas of particular need.

As a preliminary general comment, it is important to recognize that the exemption of interest on municipal bonds from the federal income tax is only one of three available "tax-exempt" borrowings. The largest amount of corporate taxable debt is purchased by individual and institutional investors which generally pay no income tax on the interest earned, even though it is ostensibly "taxable." The major such investors are pension and profit sharing plans, both public and private, as well as foundations and local governments. The second type of such investor (and one that is destined to expand) is the group of individuals who are putting money into the KEOGH and IRA plans (with a temporary deferral of income tax liability). Also included in this group of tax-exempt investors are those who, while ostensibly receiving taxable interest, do in fact shelter such taxable interest with allowable losses, particularly with the advent of ACRS. Municipal bonds are the third type of tax-exempt financing, of course.

It has been variously estimated that the total amount of interest paid on all debt is between $500 billion and $900 billion a year. It would be most helpful if an analysis were made relating the total dollars of interest taken as a deduction to the total dollars of interest reported as income. It should then be possible to determine the total federal income taxes collected on this interest income. We have seen estimates that the average rate of taxation on "taxable" interest is in the neighborhood of 10% which, of course, at $500 billion of interest expense, indicates that $50 billion of income taxes are collected on interest income. We have no way of dealing properly with these estimates but such capability is certainly available to the Committee.

With regard to industrial development revenue bonds themselves, both for industrial and commercial purposes, we feel that they play a valuable role in stimulating capital formation and thus the creation of employment, as well as increasing the tax collections of all the governmental units involved. With this preamble, however, we recognize that it is easy to abuse the program.

Cities in particular are always trying to determine whether "industrial" jobs are better than "service" jobs. It is a difficult choice to make in the abstract and even sometimes difficult to make in particular situations. If increased employment is our national goal, a job is a job, regardless of the classification of the employees.

We would suggest, therefore, that "industrial" development revenue bonds be encouraged with a limit of $10,000,000 per city for any one company, and we further recommend that the present capital expenditure limitation be removed. In other words, move the $1,000,000 to $10,000,000 and so allow up to $10,000,000 of IDB's for any facility. The imposition of capital expenditure limits is an unnecessary, complicating burden and is especially restrictive to high technology industries with their large research and development capital expenditures. We further suggest that the ACRS be continued. The rationale for this entire group of suggestions is that companies should be encouraged to expand and that no restrictions should be placed on them other than the $10,000,000 total of outstanding bonds per company per city. If, in years to come, the economy is booming and jobs are being created at an acceptable rate, the availability of both ACRS and tax-exempt financing should be reviewed. During the next few years, at any rate, we believe all encouragement should be given. In the meantime, perhaps certain commercial uses should be prohibited in order to curb certain perceived abuses.

We feel that the restrictions above are such that "umbrella financing" should be permitted within the $10,000,000 limit per "group" of small companies, particularly since "umbrella financing" is characteristically of most benefit to small business. In permitting "umbrella financing," the separateness of each bond issue should be based solely on the purpose for which the bonds are issued, and not also on the presence of a separate indenture and some "separate security," and additional requirement imposed under the old rules. The separate indenture/security requirement unnecessarily inhibits pooled security revenue bond financing of projects for more than one small business company.

With respect to tax-exempt financing for non-profit hospitals, we strongly urge that this exemption be continued, but concurrent with this recommendation is the further recommendation that such issues be allowed only in conformity with each state's certificate of need procedure. While there is a move to phase out the federal involvement in certificate of need, we believe it is a worthwhile control on capital expenditures by health care facilities and each state should be encouraged to establish and continue its own certificate of need process. This recommendation is somewhat parallel to the local approval concept, and compliance with the State Certificate of Need requirements should be a precondition to the availability of tax-exempt financing for non-profit health care facilities.

With the restrictions suggested above, as well as the requirement for a public hearing, we believe the 1% contribution by the governmental unit is unnecessary and unduly complicated. With the limited availability of tax-exempt financing in accordance with the above restrictions, there should be no further impediment placed upon the issuance of such bonds.

Particularly with industrial development projects, many cities and counties are actively seeking job producing facilities for their community. Once such a project has been secured, it places an undue burden on that municipality to make a local contribution before the sought-after project can go ahead. Mention has been made of a real estate tax abatement as a local contribution and my own reaction to that is extremely negative. In

Minnesota we have always been careful to say that even though a facility may be financed with tax-exempt bonds, the project must pay the ordinary real estate taxes assessed against everybody else. Only by doing this do we secure the double benefit of both jobs and enhanced tax base.

The requirement for registered housing bonds is being accepted by the market, although it is somewhat expensive and a nuisance. It works best on very large issues. A variation of this requirement and one that would be even more restrictive than registered bonds is to require that all IDB issues be "Blue Skyed" in their respective states, so that a public offering can be made. This would curtail considerably the use of IDB financing in situations where taxable financing is also readily available, albeit, at a higher interest rate and more restrictive terms. We would be glad to provide additional information on this suggestion.

The requirement that information concerning the issuance of revenue bonds be reported to the Internal Revenue Service is a present requirement of the Internal Revenue Service for IDB's larger than $1,000,000. The filing requirement for non-IDB's would be a new requirement but could certainly be done if it doesn't place an undue burden on the Internal Revenue Service. Alternatively, and perhaps more effectively, the issuance of all the tax-exempt obligations discussed herein could be reported to a state agency with an annual report to the Congress. This would give the reporting requirements sufficient certainty that a better understanding of the annual volume of such financing could be secured over the next several years.

The proposal that the highest elected official or elected legislative body approve the issuance of the industrial revenue bonds is workable and worthwhile. In Minnesota, a public hearing by the local governmental unit, upon 15 days' published notice, is required by state law. After the public hearing, and assuming the governing body approves the issuance of the bonds, the project then is submitted to a state agency for its approval. This procedure is working well and has not inhibited good developments. It has given the public an opportunity to testify for or against particular projects that may be deemed unfairly competitive, hurtful to a downtown business section in a smaller community, or environmentally questionable. Should this proposal become federal law, a reasonable grandfathering provision should be included so that appropriate legislative changes can be made for those issuers over which no elected official, or elected legislative body, has any authority, but something on the order of eight months should take care of any such grandfather requirement.

With regard to the restrictions on investment yield, we think this is unnecessary and unproductive. There are in existence a number of regulations promulgated by Treasury which seem to sufficiently address the situation without being onerous. As a matter of fact, in the present market, it is very difficult to "commit arbitrage" since borrowing at a

13-14% interest cost and reinvesting in short-term Treasury obligations at 12½-13% is automatically "yield restrictive."

We do not believe that the non-deductability of interest paid on money "borrowed" to purchase municipal bonds should be expanded. At the present time, it is important that banks in particular be encouraged to purchase municipal bonds and it is equally important that banks in particular be encouraged to issue certificates of deposit to investing municipalities. Particularly in the smaller towns, if the municipality has money to invest, it should be done in a certificate of deposit with the local bank to keep the money at home.

With regard to the minimum tax, we have no position on the minimum tax concept in general, except to recommend strongly that tax-exempt interest, in itself, not be subjected to the minimum tax inasmuch as it raises at least the implication that tax-exempt interest is indeed somewhat taxable. This has adverse consequences in many areas and may well trigger a "tax call" on hundreds of outstanding bonds.

Any of the above-discussed restrictions should be prospective only with ample lead time to avoid a disruptive rush to market. In today's market, and in the past, many short term revenue bonds of two to five years have been issued with a balloon maturity in expectation of the issuance of long term definitive bonds to refund the short term bonds on or before their maturity. Such refunding bonds should also be free from substantive restriction on eligible projects.

If any of these ideas, suggestions and recommendations appear helpful and interesting, we would be pleased to cooperate fully in working with the Chairman and members of the Committee, and their appropriate legal and economic advisors, to develop the suggestions in detail. Certain workable legislative language on public hearings and the definition of "industrial" is embodied in Minnesota Statutes Chapter 474.

FWP

4/2/82

Bill Frenzel PS 205

QUESTIONS AND ANSWERS

PREESHL

Q. Do you think that the issuance of Industrial Revenue Bonds increases the interest rates on General Obligation Bonds of cities and school districts?

A. In general, no. Municipal Bond buyers generally follow established patterns. It's hard to sell a G.O. buyer any revenue bond. The only exception seems to be the highly rated (AAA and AA) revenue bonds.

Q. Why has the historical spread between tax-exempt and taxable bonds narrowed?

A. We see several reasons. The reduction in the maximum tax bracket from 70% to 50%. The increased use of techniques to shelter taxable interest (KEOGH, IRA, ACRS). The reluctance of individual municipal investors to purchase bonds due beyond the year 2000, since past experience has been bad.

Q. Does the use of IDB's reduce federal income tax collection?

A. I don't think so.

1. If a borrowing is done at a lower interest rate, the interest deduction is less. Therefore, 46% of the savings is paid as increased Federal Income Tax—regardless of any other effect.
2. There is no assurance that the alternate taxable debt will be bought by someone who pays income taxes on the interest income. Zero coupon bonds are a dramatic case in point.
3. If the project would not go ahead without tax-exempt financing, the fact that is does go ahead results in increased employment, with the resulting increase in taxes paid by employees and the company.

Mr. **Rangel**. Thank you, Mr. Preeshl. Any questions from the members?

Mr. **Ford**. Mr. Chairman, once again I don't have any questions but I would like to again just thank the witnesses, especially those from my neighboring States, Mr. Martin from Georgia and Mr. Morgan from the State of Mississippi.

Mr. **Rangel**. Does staff have any questions they want to submit for the record? If not, let me thank you on behalf of the chairman of the full committee for your contributions you have made to our deliberations.

The record, as you probably know, will remain open for the remainder of the week. Thank you for your contribution. The committee stands adjourned subject to the call of the Chair.

[Whereupon, at 1:45 p.m., the committee was adjourned, subject to the call of the Chair.]

ADMINISTRATION'S FISCAL YEAR 1983 ECONOMIC PROGRAM

WEDNESDAY, MAY 5, 1982

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met at 10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. The committee will come to order. Will our guests please find seats.

Mr. Secretary, welcome to the meeting this morning of the Committee on Ways and Means. It is always a pleasure to have you here to discuss the direction that should be taken to address the economic problems of our country.

You and I, and Barber Conable, spent 5 or 6 weeks together in constructive negotiations, Mr. Secretary. I think we accomplished a great deal. The fact that we agreed upon the magnitude of the deficit was in itself an accomplishment. I think we have to continue to work in the real world.

In my opinion, there will be opportunities for members of this committee and members of the administration to cast some courageous votes this year. I think that if we can work in a cooperative manner—and I hope that we will—problems will be solved.

Mr. Secretary, I think the American people are tired of you and me. I think they are tired of the Congress and the White House because we are dillydallying around with their personal futures and with the economic future of this country.

I am ready to go to work, and I am sure you are too, Mr. Secretary. I hope that my colleagues on this committee are ready to put their shoulders to the wheel, because I think it is time that we stop the shadowboxing and come down to the real world and solve the problems that confront this Nation.

Mr. Conable, do you have a statement?

Mr. Conable. Welcome and thank you, Mr. Chairman. I think you set a very good standard for us this morning. I think we are all agreed that we ought to let the process work now. I regret that our earlier negotiations did not succeed. They were, of course, postulated on arriving at a total package.

We failed to do that, and so we are back to ground zero. And so we are going to approach this now in a more normal legislative process than the effort we made to bypass it. I think it is important that we consider in short the budget as presented, rather than the hopes we had for resolving it at some other set of figures.

I am totally in accord with the chairman. I appreciate the tone he has set, and so I am not going to say anything more at this point except to welcome you also, Mr. Secretary. We count on your leadership. We count on the serious expectations the American people have of this body to make it responsive in the course of negotiations which are necessary to get the economy moving again.

Thank you.

Chairman **Rostenkowski**. Mr. Secretary, welcome. You may proceed with your statement.

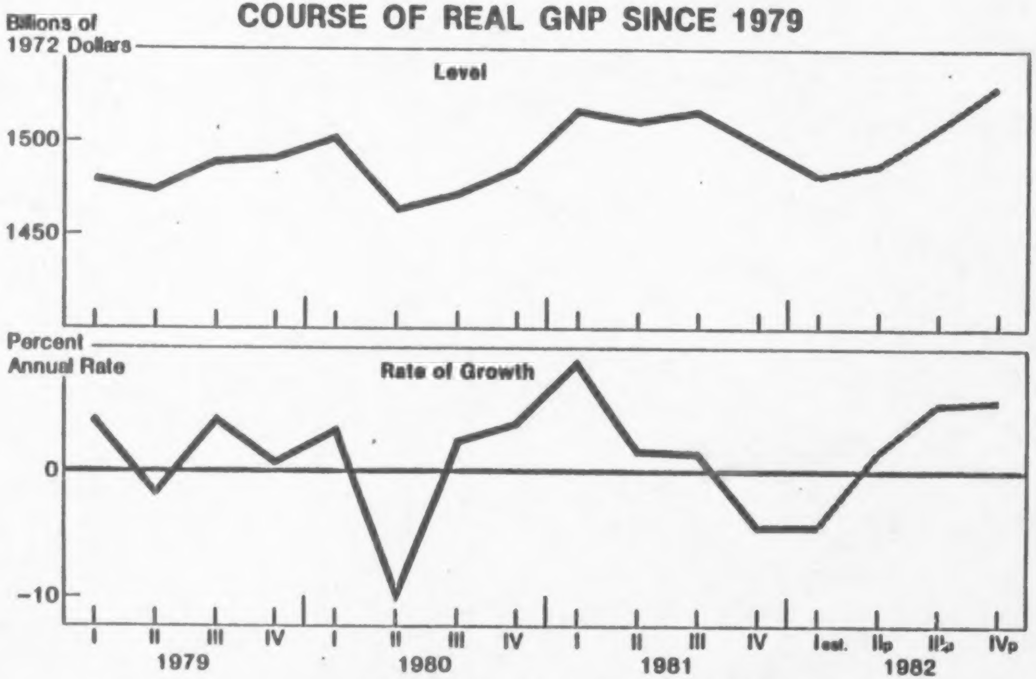
STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary **Regan**. Thank you, Mr. Chairman and Mr. Conable. I am here today at your request to discuss the challenges for dealing with the Federal budget for fiscal 1983 and beyond, and the tax policies that should accompany that budget. Let me set the stage for our discussion by describing the interrelationship between Federal taxes and the economy.

The economy continues in the grip of one of the longest recessions since the decade of the 1930's. While according to the conventional measures, we are now experiencing the second recession in 2 years, there has in fact been no sustained growth in real GNP since early 1979. This is clearly seen in the attached chart 1, that I have with my statement. The past 3¼ years have been a period of protracted economic stagnation.

[A chart follows:]

CHART I



COURSE OF REAL GNP SINCE 1979

p - projected, based on rates of growth underlying 1983 Budget.

Secretary **Regan**. The causes of the problem are years of excessive money growth resulting in rising inflation and interest rates, continuously escalating tax rates, and increasing diversion of our production capability to meet the demands of ever expanding Federal spending.

Mr. **Gibbons**. Mr. Secretary, for some reason we are not picking you up loud and clear. It is not your fault; it is the microphone's fault. Could you try to move that microphone closer to you?

I think we just have not very sensitive mikes and you have to get real close to it. That is the problem. Could you put it a little closer to you? I hate to be so technical, but I am sure the people in the room want to hear you. You need our mikes rather than the television mikes, Secretary Regan.

Secretary **Regan**. In spite of the continued slide in the first quarter of 1982, there are some hopeful signs. Excess inventories are being drawn down at a rapid rate. This is typical of the last stages of a recession. Retail sales are rising. Housing starts are up slightly for the fifth month in a row—although still at a deplorable level. Durable goods orders are no longer falling but have leveled off. And, very important for the financial well-being of all Americans, whether of working age or retired, inflation continues to fall.

More importantly, we have in place a sound, long-run tax system. If we assure business and individual taxpayers of our determination to secure that tax system in place, it will help bring an early end to the current recession, and it will provide the tax climate for strong, continuous growth of income, saving, investment, and employment. That tax system, with a healthy economy, will generate as much revenue as Government should reasonably be allowed to spend.

The severity and duration of the recession has required substantial revisions in the estimates of the Federal budget for the next several fiscal years. We all should have learned by now that projecting budget results is an extremely uncertain business, and we should, therefore, entertain serious reservations about the current estimates of future budget totals. Notwithstanding, it is clear that the net budget results for the next several years almost certainly will be much larger deficits than we had earlier foreseen.

The deficits projected for fiscal years 1983, 1984, and 1985 without further Government action—as much as $182 billion, $216 billion, and $235 billion, respectively, according to the CBO's current estimates—must be seen as measures of disarray in our fiscal affairs, not merely as the untoward consequence of unsatisfactory performance of the economy. There has been, and continues to be, dispute over the economic impact of these deficits. Whether you believe that these deficits in and of themselves can or will prevent the kind of robust and extended recovery all of us seek, you cannot deny that these deficits reflect failure to match the Federal Government's demands to its revenue resources. None of you in Congress or those of us in the administration would deliberately plan deficits of these magnitudes. We have no choice but to move now to put our fiscal house in order.

Our basic and urgent concern with the Federal Government's finances must be to insure that our fiscal plan for the next several years will not impede the economy's recovery from the prolonged recession of the last 3 years, nor imperil its sustained expansion. For the long run, reducing and eliminating deficits must be the fiscal reflection of a strong and growing economy.

Recovery and expansion will be set back if the fiscal plan we adopt allows the Federal Government to preempt too large a share of the economy's productive resources through its spending programs. Recovery and expansion will also be threatened if Federal deficits claim too large an amount of the economy's gross private savings. The greater the proportion of gross private saving which must be allocated to financing the Federal deficit, the less the amount of saving which will be left to the private sector.

We have learned, or at least we should have learned, that we cannot consume our way into sustained economic progress. Growth in the economy—in employment, productivity, output and incomes—depends critically on increasing the amount and improving the quality of the capital with which our labor force is employed. If we have to devote significant amounts of our savings to financing Government deficits instead of capital formation, we must suffer the consequences in less certain recovery and growth.

The principal way to reduce Government deficits, the only way to do so without imperiling the saving which must finance both deficits and capital formation, is by cutting the growth in Government outlays. Any changes in the economic recovery program which reduce real growth will tend to worsen the budget picture. Changes which reduce individual or business saving by as much as, or more than, the deficit will only worsen the situation in the credit markets. We must, therefore, make every effort to reduce spending growth. If we must add revenues to make up any shortfall which less spending restraints may leave us, we must do so in ways that will least impair incentives for saving, investment, and personal effort.

The measures we take to reduce these deficits should be closely guided by certain basic criteria. One of these must be that we will not be panicked into hastily designed spending changes, or revenue increases which would have the effect of discarding the policy objectives set last year. The fiscal measures which were enacted in 1981 had two major aims. One was to reduce Federal spending and its preemption of the economy's productive capability; the other was to moderate the adverse effects of our tax system on incentives to work, to save and invest; to undertake new businesses; to innovate; and to develop new products and new production processes. These are the kinds of activities upon which economic progress depends. We made great progress in pursuit of these goals last year. The actions on the budget clearly reflected a resolve to get Federal spending under control, to slow the rates of its advance, and to increase the efficiency of Federal spending programs. The Economic Recovery Tax Act takes us a long way toward the goal of a tax system far less biased against saving, investing, and productive personal effort than was prior law.

As a corollary, we must be certain that if any revenue-raising measures must be undertaken, they will not blunt the thrust of ERTA toward affording us a more efficient, more dynamic, and more productive economy. Some have urged us to revoke the incentive-creating tax cuts enacted last year. The result would be lower real growth for many years into the future. Such a self-defeating major change in a permanent tax program to handle a temporary problem is not an acceptable solution to our budget difficulties. We must not renege on our promise to individual taxpayers to provide substantial, evenhanded reductions in their bracket rates and to insulate those reduced rates against inflation by indexing. The full 3-year, 25-percent individual rate cuts followed by indexing are a policy imperative.

The personal tax rate reductions in the ERTA are not substantially larger between 1981 and 1984 than the continuing bracket creep and the payroll tax increases of 1981 and 1982. In fact, there was a net personal tax increase of roughly $15 billion in 1981. In 1982, taxpayers will barely break even. Not until 1983 and 1984 will there be any real tax cuts for some families. Taxes will rise again in 1985 due to a scheduled social security tax increase.

Take, for example, a one-worker, four-person family at the median income level of $24,000 in 1982 who has received and will continue to receive a cost-of-living increase each year to keep its real income constant. The attached graph shows what would happen to this family if certain changes in the personal tax cuts were enacted.

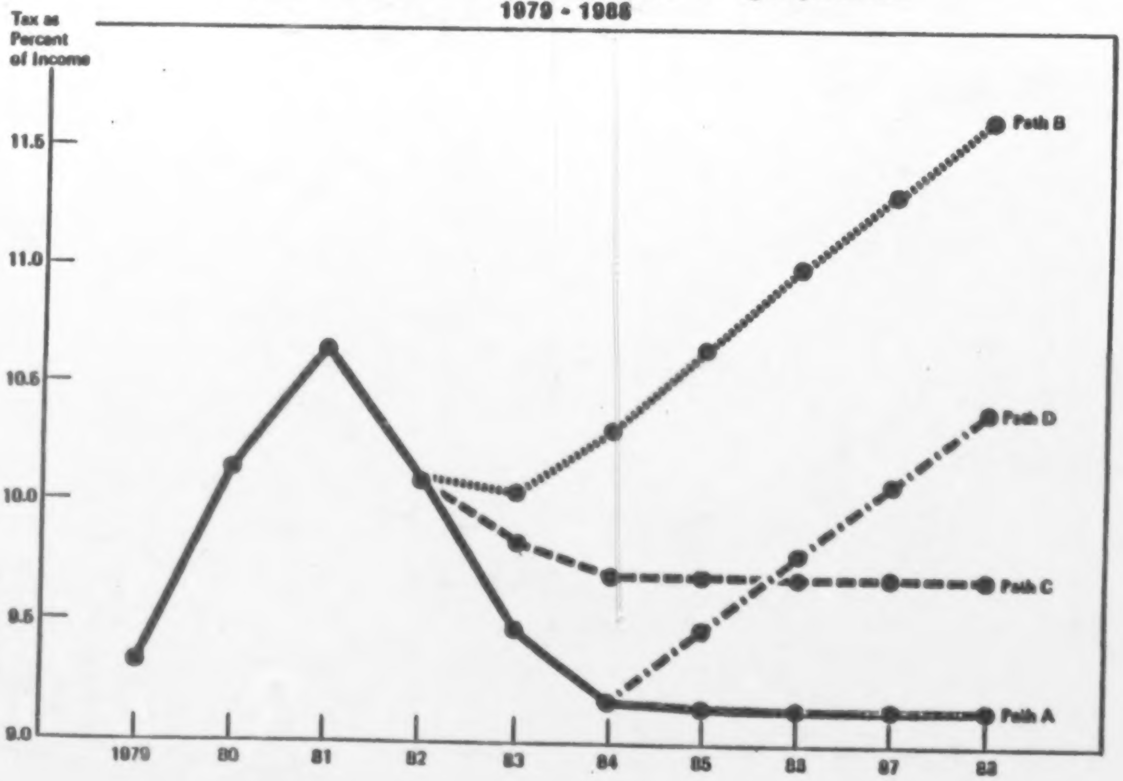
[A chart follows:]

CHART II

Median Income Family of Four Earning $24,000 in 1982

Average/Marginal Tax Rates After Cost of Living Adjustments

1979 - 1988



Secretary REGAN. Path A shows current law, the 3-year tax cut plus indexing.

Path B repeals the third year and indexing.

Path C substitutes indexing for the third year as of July 1, 1983.

Path D repeals indexing, but keeps the third year tax cut.

The graphs show the increases in average and marginal income tax rates since 1979, the year following the last tax cut bill prior to ERTA. The 1¼-percent rate cut under ERTA for 1981 (5 percent for 3 months) was not enough to prevent a large tax increase due to bracket creep in 1981, and did nothing to offset the bracket creep in 1980. The percentage of income paid in tax rose from 10.15 to 10.66 between 1980 and 1981, and up from 9.34 percent in 1979. The taxpayer rose from the 21 percent marginal tax bracket to the 24 percent bracket.

Under the full 3-year income tax cut plus indexing (Path A), by 1984 the taxpayer will experience a decrease in average and marginal tax rates to levels a shade below those of 1979. The second and third years of the tax cut offset the bracket creep of 1980–84. Without indexing, however, even the third year of the tax cut fails to provide permanent tax relief. Inflation and bracket creep will repeal the third year of the tax cut by 1985 and the entire tax cut [measured against 1980 tax rates] by 1987. All improvement in incentives would be lost.

Repeal of the third year and indexing would cause average marginal tax rates to bottom out at roughly 1980 levels in 1982 and 1983 and rise steadily thereafter. There would be no meaningful tax cut at any time. Taxes would remain at or above the levels which helped bring on the 1980 and 1981–82 recessions.

Substitution of indexing for the third year would leave average tax rates well above 1979 levels and produce higher marginal tax rates than under ERTA. Of course, this means reduced incentives for most taxpayers.

As this graph clearly shows, repeal of the third year and/or indexing would result in substantial tax increases for the median income families of America.

Only Path A is enough of a tax "cut" to offset the combined effects of bracket creep and payroll tax rate increases above 1980 levels.

There are those who would preserve the business portions of ERTA and cancel most of the remaining individual tax rate reductions. Such a move would be extremely counterproductive to business as well as to individuals.

In my years at Merrill Lynch, I came to appreciate the importance of the individual in his or her role as saver, investor and entrepreneur, as well as employee and consumer. Those who think of business only in terms of large corporations forget the millions of partnerships, proprietorships and subchapter S corporations run by entrepreneurs whose profits are taxed at individual tax rates.

As for employees and consumers, consider the effect of suspending the third year of the tax cut and indexing on the cost of labor and the standard of living of the American family.

Labor accounts for between two-thirds and three-quarters of the total cost of inputs in most years for most products and industries. Labor inputs outweigh capital inputs 2 or 3 to 1. It is time to remember that taxes on labor and the resulting higher labor costs are extremely damaging to American business.

Tax rates on labor at the Federal, State and local levels have risen until it now costs a firm more than $1.70 to compensate a worker for a $1 increase in the cost of living. Without indexing, it could cost $2.50 or more in the 1990's. Any wage increase, whether merely COLA's or a real wage hike, would increase workers' taxes and tend to push labor costs up faster than the prices the firm receives for its products. The likely consequence of such a tax situation would be falling profits and falling employment.

Labor would absorb a substantial portion of the rising tax burden, amounting to several hundred dollars per worker in higher taxes by 1986. This is only the direct cost. The weaker economy, reduced saving, investment and growth, lower productivity, and reduced competitive position of American labor in the world economy would lower the market wage itself, reducing the familys' real earnings by hundreds of dollars more. American workers and savers are the primary customers of American business. There is no way such an impact on the real income of its customers could be good for business.

We cannot hope to provide economic recovery by raising the cost of saving and the cost of being employed.

Similarly, we must not break our commitment to business taxpayers to provide a capital recovery system which materially reduces tax-induced extra cost of capital. We must hold on to the accelerated cost recovery system. To insure that ACRS is fully effective, we must retain ERTA's "safe-harbor" leasing provisions, although modifications to prevent abuse may be desirable.

Stability in tax policy is essential for private sector planning and economic recovery. Millions of firms planning billions of dollars of investment decisions must now be in a situation of great uncertainty with respect to leasing, ACRS, and other provisions. The decisions of the Congress regarding ACRS and related provisions have the power to unleash a flood of investment or to choke off tens of billions of dollars of spending on modernization and expansion of plant and equipment. Until the political decisions are made, the economic decisions and the economic recovery are likely to remain "on hold."

It is unlikely in the extreme that tax increases alone could succeed in balancing the budget. First, they would weaken the economy, and be partially offset by slower growth. Second, they would encourage higher spending. In spite of the fact that the tax receipts of the Federal Government rose by $244 billion from fiscal year 1977 to fiscal year 1981, the Government ran deficits in the fiscal years 1978 through 1981 totaling $194 billion.

We must, in short, avoid tax increases that would cancel ERTA's incentive-enhancing effects.

Of course, most tax increases tend to reduce the net rewards to the individuals who provide our production muscle—labor and capital services. This fact gives added emphasis to another of our guiding principles: reducing the deficits must be pursued mainly by reducing Government spending.

Let us put the Government spending issue in perspective. Last year, President Reagan presented a long-range budget strategy which aimed at slowing the growth in Federal outlays sufficiently so that, with growth in the economy, Federal spending would claim a decreasing share of total output. The aim was to reduce the Federal spending-GNP ratio from 23-plus percent in 1981 to 19.3 percent in fiscal year 1984. As matters now stand, we are nowhere near achieving that goal. With the Congressional Budget Office's present estimates of current service outlays, the projected ratio in each of the fiscal years 1983 through 1985 is 24.3 percent. To be sure, some of this huge difference between the goal the President stated and the CBO's current projection is attributable to the drastic downward revision in the projections of GNP. But if we were to achieve a ratio of less than 20 percent of GNP without an enormous reduction in spending, GNP in 1984 would have to be almost $1 trillion greater—about 25 percent more—than CBO currently projects for that year. It is clear that the shortfall in economic growth accounts for only a small fraction of the huge difference between the projected and the desired spending-GNP ratio; the overwhelming proportion of the shortfall results from an increase in spending.

There simply cannot be any question about the fact that the main line of attack on the deficits which fall out of the CBO's projections must be to reduce the Federal Government's spending. If we settle for the Federal Government's share as being one-fifth of the GNP in fiscal 1984, we face the challenge of reducing outlays in that year by about $160 billion.

I do not want to belabor this committee with the urgency of reducing the growth in Federal spending if we are to set our feet on a course of true fiscal discipline. Moreover, given the magnitude of the deficits which appear to be in prospect, prudence urges that we also earnestly address the possibilities of reducing these deficits with revenue increases. But this clearly does not mean that the preferred way to close the gap between outlays and revenues is by tax increases We must not attempt to balance the budget on the backs of the individuals who work and save, who produce our national income and who pay our taxes.

As the members of the committee are aware, the President has proposed a number of tax changes which seek to improve the structure of our tax system and to improve compliance with the tax laws. We will continue our search for tax revisions of this nature and will welcome suggestions along these lines.

Notwithstanding the substantial progress made last year, the structure of the Federal tax system can be further improved, and with these improvements can come added revenues to reduce projected budget deficits as we move to control Government outlays. But the fundamental elements of last year's historic tax cut, the accelerated cost recovery system and the full marginal rate reductions, must remain in place.

Thank you, Mr. Chairman.

Chairman Rostenkowski. Mr. Secretary, you and I know that we made some progress, at least in the budget negotiations, with respect to the size of the projected deficits and what ought to be considered with respect to enhancing the revenue base. I gather from your statement that we are moving back to our old battlelines. Are we saying that the negotiations were meaningful, but only meaningful in that room?

In reading your statement, I make the honest appraisal that this was a good statement last February. It appears that we have wasted 4 months.

I want this administration to present something more specific, beyond what was suggested last February, in terms of revenue enhancement proposals. What specifically are you recommending? What specifically do you recommend with respect to reduced spending and tax increases?

If we accepted the Administration's February budget, the deficit would still be $137 billion in fiscal year 1983. In 1984, it would be $144 billion. You and I know that most Members of Congress find these deficits totally unacceptable.

I implore you, Mr. Secretary, to tell the President that this is his opportunity to lead. Come back to this committee, if you can do it today, and present us with specifics, so that we can cooperate in your program. We are playing a dangerous game. I want the budget process to work. I want the Committee on Ways and Means to execute its responsibilities. However, I think the President has both the opportunity and, more importantly, the obligation to lead.

Mr. Secretary, would you be kind enough to be more specific and give us guidance as to precisely what the administration recommends to increase revenues?

Secretary **REGAN**. Well, I will try to set it in a frame of reference which I think both you and I understand, Mr. Chairman. The projected budget deficit has gotten progressively worse as the year has gone on. CBO itself has been changing its forecasts of what the budget deficits will be. We in the administration realized that this was happening.

As you know, the law passed by Congress in 1974 says the President shall send a budget to the Congress, and that the Congress should either pass that budget or, if not having passed that, should propose a budget of its own in a budget resolution due by May 15 of each year. From that point of view, Mr. Chairman, we sent our budget up. Apparently, it has been rejected.

The President then acted. He showed leadership in sending his chief of staff to meet with the Speaker to suggest that we get together and start discussions to see if something could be done about the situation.

Chairman **ROSTENKOWSKI**. Mr. Secretary, your problem was in the Senate as well. We all recognize that the Senate is not controlled by Tip O'Neill. Your stalemate came in the Senate. We all recognize that. We then proceeded with the budget negotiations. Mr. Secretary, I interpret that in itself as a concession.

In those negotiations, I think we were bold, and I think we were accommodating. We knew when the ground rules were set that there would be points upon which we would not be able to agree, and that our principals would have to decide. I was cautioned by many Members not to fall into a political trap.

So, the problem with the budget is not only in the House of Representatives, but it is also in the Senate. Do you agree, Mr. Secretary?

Secretary **Regan**. The problem is in the Congress, I agree with you on that. I would also say, Mr. Chairman, that from the angle of the group that was negotiating, there were many things on the table. You will recall, and Mr. Conable will recall, that we agreed that none of this was binding on anybody.

To imply now that the tax amounts that we put forth in an attempt to seek a compromise are now binding on us without all of the other things being binding on other people there, is to distort what we had agreed upon.

There is nothing on the table in the way of tax concessions from the administration at this time, just as there is nothing on the table from any of the Members of Congress regarding possible budget cuts. We are willing, however, to enter into further discussions leading to reduced deficits by a combination of budget cuts and taxes.

Chairman **Rostenkowski**. Then, Mr. Secretary, tell me this. Where would you cut outlays?

Secretary **Regan**. Where would we do what?

Chairman **Rostenkowski**. Where would you cut outlays? How precisely would you reduce the deficit? What services would you reduce?

Secretary **Regan**. At the present moment, my colleague, Mr. Stockman, is telling the House Budget Committee exactly where we would do that and the like. As you know, one of the main areas that we think you should look at is somewhere in the area of nondefense discretionary spending. We think about $6 billion of cuts could be achieved there.

I think that both sides agree that there should be something done in the area of entitlements. We have to look at that as one of the fastest-growing areas of the budget. The President was willing to cut in defense, even though he thinks that may be foolhardy.

Chairman **Rostenkowski**. However, you recognize that the argument came over the size of the cuts that would take place. We felt that the proposed cuts in the social programs were a bit more severe than the proposed defense cuts, Mr. Secretary. Therefore, the area which I pointed out that was very sensitive and fragile was entitlement cuts. Both of our principals made a commitment not to cut certain cost of living adjustments. Both of our principals.

Secretary **Regan**. But you also remember that it was the President who, when he saw it was a stalemate between what certain Members of the House wanted and what certain Members of the Senate wanted in the way of budget cuts and what the administration wanted, who took the extra step and said, "I will go in the middle." But that was rejected.

Now, I do not see how you can expect any one to go any further than in the middle, when there is such a division. As a person from Wall Street, I know that ordinarily when you have a bid and an offer, the sale takes place in the middle.

Chairman **Rostenkowski**. Mr. Secretary, you know there was a middle ground last year between 1 year and 3 years—that was 2 years. However, that argument did not work last year. It appears that it works this year, but it did not work last year.

Secretary **Regan**. I do not recall 3 being the limit. I thought it was between 1 and 5, and that was 3.

Chairman ROSTENKOWSKI. No, Mr. Secretary. As we looked at the tax cut last year, we suggested a compromise between 1 year and 3 years—the number in the middle was 2 years. That fell on deaf ears last year.

Mr. Conable will inquire.

Mr. CONABLE. Thank you, Mr. Chairman. Mr. Secretary, I think you have accurately described the condition we have right now, which is that we still have to rely on a balanced package, ultimately, to insure an equality of sacrifice and an appropriately balanced Government program. It would be inappropriate for us to expect you to go back to figures that were negotiated as part of a hoped-for package, and to, accept now any isolated element just because we had talked about it as part of a package..

And I think the ball is in Congress court. I think that we have got to let the procedure go ahead now. I think we have failed to short circuit that process because of the urgency of this situation. And I expect that the administration will make recommendations in all three of the sensitive areas that are involved, but will not settle one without settling the other two also. That would be inappropriate.

It would be bad faith to start with the figure in taxes that was part of our earlier negotiation, for instance, and ignore the rest because it would discourage the possibility of further bipartisan negotiation. And I hope we can have some further bipartisan negotiation.

The process involves give and take. It involves balance, it involves some degree of packaging the resources to meet the needs of the government and the people.

Mr. Secretary, I note your statement that safe-harbor leasing should be retained, but perhaps should be modified. I agree with that statement. We currently have a situation in which safe-harbor leasing cannot function appropriately because of the uncertainties and risk involved. I wonder if you could give us some guideline as to how it should be modified.

It seems to me, as a person interested in this area, that we ought to permit a market in tax benefit transfers to accurately reflect the tax value of the transferred, unused tax credits so that those who are selling unused credits would get the current market value of those credits for a capital investment purpose, which was the whole goal of the Tax Act.

Now, can you give us any further guidance as to how you would like to see safe-harbor leasing modified so as to avoid the abuses you mentioned in your statement?

Secretary REGAN. Well, Mr. Conable, we would like very much to work with members of this committee to come to a satisfactory solution to this problem as quickly as we can. That way business will know where it stands and this tax provision will help the recovery rather than delay it.

What we are thinking of currently is along the line of putting a cap on the amount of the tax benefits that could come from buying tax benefits from another corporation.

Mr. CONABLE. So that a profitable company could not reduce its taxes below a certain percentage of the total amount of taxes otherwise owed?

Secretary **Regan**. That is correct. Plus the fact that they could, in no event, go back into previous years' taxes and get a refund as a result of leases they might have purchased in the current year, Mr. Conable. I think that something along that line would be fair to both sides. That is, we would still have a market in these rights, and that would help promote in capital formation, but at the same time it would not get into any excess, as I think has happened from our experience in looking over what happened in 1981. We did get into some excesses.

Mr. **Conable**. Would you suggest that that be done immediately or as part of some sort of an overall settlement? It does seem to me that we have currently an intolerable situation in the safe-harbor leasing area.

Secretary **Regan**. Well, it would be my hope, Mr. Conable, that whatever we are going to do in the way of spending cuts and possible revenue increases be done rather quickly. If that is not to be the case, if it looks as though we are going to have some type of stalemate or delay in this process, perhaps in leasing we should go on that alone and try to straighten it out by itself.

Mr. **Conable**. Thank you, Mr. Secretary.

Chairman **Rostenkowski**. Mr. Gibbons will inquire.

Mr. **Gibbons**. Mr. Secretary, I listened closely to your statement, and I understand Mr. Stockman is also addressing the Budget Committee this morning. And what I gather from your statement and the gist of Mr. Stockman's statement, is that we submitted our budget—I am talking now about the administration—in February. It has not been acted upon yet; we are sticking to that budget; we do not make any major suggestions of changes; and the House and the Senate ought to get on with either accepting or rejecting that budget. Am I correct?

Secretary **Regan**. In general, Mr. Gibbons, that is our attitude. We tried, as the Chairman and Mr. Conable have pointed out, over the last 5 or 6 weeks to reach some type of agreement on that budget or on a compromise budget.

Mr. **Gibbons**. I am aware of that.

Secretary **Regan**. And having been unsuccessful in that, rather than have us now come up with something else new, we would like to see if the Congress has any suggestions for us.

Mr. **Gibbons**. Well now, I am sure we will have some, but let me ask you this first. Does the administration suggest any new taxes?

Secretary **Regan**. No. But closing of loopholes, structural modifications, trying to get some of the back tax revenue that is due us or to collect unreported taxes—things of that nature is what we currently have. Those are the types of things we would like to do.

Mr. **Gibbons**. And how much would that amount to in the next fiscal year?

Secretary **Regan**. Well, our original projections were $13 billion in the forthcoming year, and $49 billion over a period of 3 years. And if you accompany that by a package that was started in the Senate Finance Committee to further enhance or get at the underground economy, you could probably increase that to, say, something in the neighborhood of $60 to $65 billion over 3 years.

Mr. GIBBONS. Over 3 years? But let us try to stick to the next year, since that is difficult enough, and you can get to them one at a time.

Secretary REGAN. It would be something in the neighborhood of $18 billion in fiscal 1983.

Mr. GIBBONS. Loophole closing, stamping out the inequities in the system and things of that sort?

Secretary REGAN. Yes.

Mr. GIBBONS. And you want us to do that for 1983, is that correct?

Secretary REGAN. Yes.

Mr. GIBBONS. OK. Now, that would reduce the $182 billion deficit down to about $160 billion. What are we going to do for the rest of the reduction? What do you suggest that we do for the rest of the reduction?

Secretary REGAN. We suggest there that there should be spending cuts somewhere in the neighborhood of about an additional $50 billion.

Mr. GIBBONS. Are you recommending that social security be cut?

Secretary REGAN. Social security is off the board, according to the Speaker and according to the President. There is a Commission studying that, Mr. Gibbons.

Mr. GIBBONS. Well, the answer is "no." Let me go to the next one, then.

Secretary REGAN. Well, may I finish one thing on that, Mr. Gibbons? While it may seem like an odd way to do things, I think you will have to plug a figure in the budget for that because we are going to have to get together on social security one way or another. I am Chairman of those funds, and the social security trust funds are going to be in bad condition after July of next year.

So, for fiscal year 1983 we have to do something.

Mr. GIBBONS. You are not recommending that we cut any social security benefits now?

Secretary REGAN. Well, at present, we are just waiting to see what the Commission will have to say about it.

Mr. GIBBONS. Well, for 1983, you are not recommending any benefits, is that correct?

Secretary REGAN. That is correct. We are not recommending any for 1983.

Mr. GIBBONS. Well, how do we get down, then? Do you recommend veterans' benefits?

Secretary REGAN. Well, I think, Mr. Gibbons, that you are going to have to plug a figure for social security. You are going to have to put at least $7 billion into the social security trust funds in fiscal 1983, or we are not going to be able to send out checks. You have to put that in.

As far as other cuts, we suggested $6 billion in nondefense discretionary spending.

Mr. GIBBONS. Do you suggest any reductions in the defense spending budget?

Secretary REGAN. In the defense spending budget, we have discussed $5 billion of cuts, plus an additional, $2.2 billion in wage freeze, at a 4-percent cap. This is a total of, call it $7 billion, or $7.5 billion in defense cuts.

Mr. **Gibbons**. I have kept a running total in my mind of where that $182 billion has gotten. And so far, you have gotten it down to about $150 billion. I do not believe that is acceptable to you, is it?

Secretary **Regan**. No. Nor should it be acceptable to you.

Mr. **Gibbons**. It is not acceptable.

Secretary **Regan**. I think what you have to do is to look at other entitlements. You are going to have to do something in that area. I think those cuts would amount to another $6 billion.

Mr. **Gibbons**. I mentioned the big ones; social security and veterans. What other entitlements do you think we ought to cut?

Secretary **Regan**. Well, I think there are freezes that have to be done on some of the pension plans.

Mr. **Gibbons**. Where?

Secretary **Regan**. I think as far as the Federal pension plans are concerned and their COLA's and things of that nature, I think you are going to have to do something there.

Mr. **Gibbons**. How much would that save?

Secretary **Regan**. Another couple of billion dollars.

Mr. **Gibbons**. So we are down to $148 billion. [Laughter.]

Well, my time is up. Maybe I will come back.

Secretary **Regan**. I think what you are forgetting is when you get to the bottom line, Mr. Gibbons, in all seriousness——

Mr. **Gibbons**. I am serious.

Secretary **Regan** [continuing]. What you have to remember is that when we get these deficits down, you have less debt service.

Mr. **Gibbons**. I agree.

Secretary **Regan**. So, you have to throw in about $5 billion or $7 billion there.

Mr. **Gibbons**. All right, we are down to $142 billion.

Secretary **Regan**. If you make further cuts in the deficits, you will certainly have interest rates coming down. If we have lower rates of interest by 2½ percentage points, there is another $7 billion of savings in the budget. Where are you now? You then have some managerial agreements that we have all agreed upon, where you sell a lot of Government holdings in lands. These would include off-shore drilling. There is about $11 billion there.

We are advocating user fees of about $2 billion. And when you add it all up, you are down to about $105 billion to $110 billion of deficit for the year 1983.

Chairman **Rostenkowski**. Mr. Secretary, how large is your tax package then? Is it a $60 billion tax package or a $125 billion tax package?

Secretary **Regan**. I beg your pardon, sir?

Chairman **Rostenkowski**. How big is your tax package? Is that a $60 billion tax package or a $125 billion tax package?

Secretary **Regan**. We have no tax package, except for the items suggested earlier which amount to $60 billion.

Chairman **Rostenkowski**. Well then, would you be satisfied with us taking your February recommendations and passing them?

Secretary **Regan**. Provided, Mr. Chairman, that the budget committees of both the House and the Senate come up with additional cuts to bring the deficits down into that area. Yes, very definitely.

Chairman ROSTENKOWSKI. Mr. Secretary, I do not know how much money you think is in the entitlement programs, but there is not a lot of money there to cut.

Mr. Pickle will inquire.

Mr. PICKLE. Well, Mr. Secretary, your presentation this morning seems to be more or less a recital of the old Kemp-Roth tax bill and the accelerated depreciation approach. And you keep saying that we are not going to solve our deficit problem unless we can plug into the entitlement program.

But, Mr. Secretary, your President and my Speaker have said you cannot get into that area, or you cannot get into the area of the tax cuts. Now, as long as you have those two saying that you cannot do it, I have to question either your sincerity or your honesty about saying we ought to do it. Perhaps we ought to, but I am afraid the only way we are going to do that is if you were to invite the President and the Speaker to go on an extended tour down the Potomac and let us go to work the next 6 months, and maybe we could do something.

But if we do not do it, we ought not to kid each other because——

Secretary REGAN. Now, Mr. Pickle, let us be a little bit fair about what the President recommended. The President was willing to go for $122 billion in tax increases——

Mr. PICKLE. I know.

Secretary REGAN. Just a minute, Mr. Pickle, and let me finish—provided that these other cuts came along. And that was rejected out of hand.

Mr. PICKLE. Right. Mr. Secretary——

Secretary REGAN. Now, you cannot say that the President did not go the extra mile. He did, and I——

Mr. PICKLE. Mr. Secretary, I am not saying——

Secretary REGAN. And frankly I do not think that sending the President down the Potomac for 3 months is a very nice thing to say about the President of the United States!

Mr. PICKLE. Well, I was going to ask the Speaker to go with him, and with you, too, Mr. Regan. [Laughter.]

Now, I want to come to the very point you mentioned. If I understood what you said to Chairman Rostenkowski, you said that your tax revisions, your proposals, are the same as those you sent up in February. Now I want to be sure we all understand. You are still recommending these tax revenue measures, and that includes completed contract accounting, energy tax credits, tax exempt IDB's, modified coinsurance, minimum corporate tax, safe-harbor leasing—with the modification you made—and right on down the list including withholding of interest and dividends?

Secretary REGAN. No, sir. We rejected the last one.

Mr. PICKLE. Now, is that still the President's proposal?

Secretary REGAN. No, it is not. We have withdrawn that last one.

Mr. PICKLE. You have withdrawn that? Well, I noticed in the negotiations last week, that the President laid on this table $122 billion in tax revenues, to be raised over the next 3 years. Can you tell us how you arrived at that $122 billion? Can you tell us what he is recommending? We need to know that. I am of the opinion now that we need to do a little in four or five areas. We need to cut spending, we need to raise more revenue, we need to cut in defense, we need to get into entitlements.

But I also say that if we are going to get into the tax revenues, how do you arrive at the $122 billion? Can you tell us?

Secretary REGAN. No, sir, I cannot because——

Mr. PICKLE. Now, you withdrew the first package and you will not tell me——

Secretary REGAN. Just a minute, Mr. Pickle, let me answer. The chairman knows that we decided, when we were in that discussion group, that we would not try to write a tax bill. We said there were many ways to raise that type of revenue, but rather than bog down and write a tax bill there, that we would leave it to the tax writing committees of the Congress to do that. So I would be interested in what suggestions this committee would have as to how to raise that money.

Mr. PICKLE. Yes, and I think the committee is going to be faced with that due to the roadblock between the negotiators. So you are right that we have to express ourselves. But I think if you are going to make a tax proposal for some revenue raisers, particularly some $122 billion, we ought to know what they are.

I think you could help the committee if you would give those suggestions because some of us are willing to try to bite the bullet. I think the American people are ahead of our leaders and trying to arrive at a solution. We all must give and take on this, and we cannot do it if one side just tries to protect their own flank.

Let me ask you a more specific question. Last year, this committee adopted the concept of expensing. But Congress passed the accelerated depreciation schedule, and that is probably more generous than the expensing. But the thinking behind the plan was to encourage investment and get business and the economy moving.

Now the administration proposes a minimum tax where the calculations are made without regard to net operating losses and without regard to the investment tax credit. Aren't we, with this proposal, actually taxing investments? Shouldn't we, perhaps, look at some changes in the ACRS rather than at a minimum tax? Can you comment on that?

Secretary REGAN. Well, I think that what we can do as far as the combination of the interworkings of both ACRS and the minimum tax—particularly as it affects the ITC—is to make certain that in no case do we go below expensing. I think we have to draw the line at expensing as the maximum amount that would be permissible. We are willing to talk about how we get there, which is the preferable way to do it.

Mr. PICKLE. Then you are saying you would consider some changes in the ACRS?

Secretary REGAN. Well, it would depend. We will have to see which is the better way to go.

Mr. PICKLE. I would be willing to look at the minimum tax if I could see that it would not be an unfair tax on the extractive industries or if it would not be taxing on capital investments. I think perhaps we ought to look at it. But we need to know what effect it will have on the economy.

So, some of us want to help. But I want to know if you are going to be for these tax proposals—these revenue raisers that you recommended—or are you just lukewarm about them?

Secretary **Regan**. In those we have recommended we will stand behind them all the way and will work with this committee to get them accomplished.

Chairman **Rostenkowski**. Mr. Crane will inquire.

Mr. **Crane**. Thank you, Mr. Chairman. I want to welcome you, Mr. Secretary. I appreciate your cooperative spirit. I share the sentiments of my distinguished chairman of the committee when he indicated that the people are tired of Congress dillydallying around on this matter of trying to provide a budget. I have found the same reaction in my own district and I think that the focus of this debate has been misdirected inasmuch as it is not a function of the executive branch to produce budgets. It is, rather, a function of this body.

All money bills must originate here constitutionally. And, therefore, all policy and the priorities must originate here. Thus, there is a great burden that falls on our shoulders and any help and cooperation that we can get from the executive branch in trying to find the answers to questions to address these problems is deeply appreciated.

We had hearings here recently on the question of alleged IRS abuses. This seems to be a very serious problem and one that concerns many Americans. We had those along with IRS' complaint that there is an estimated $80 to $100 billion in revenues that are not being collected today because of tax avoidance on the part of people who feel the tax code is inequitable.

It seems to me in trying to figure out how to achieve a fairer tax code that the so-called flat-rate tax has much to recommend it. I would feel, based in fact on part of your own statement to Senator DeConcini, that it seems like it might be the fairest tax of all. It seems to me that if the American people felt that the taxes were equitable and fair we would not have that level of tax avoidance.

I would just like to find out, first of all, if that is your assessment as well.

Secretary **Regan**. Well, I think it is something, Mr. Crane, we definitely should study. A former Secretary of the Treasury told me that the longer I stayed as Secretary of the Treasury, the more I would become enamored of a flat tax. I am beginning to think he is right. It does seem that the more we try, the more complicated the tax code becomes and the more we have these complicated decisions to make as to whether we should favor one group over another by whatever actions we take in changing the tax code.

Accordingly, a flat tax does have possibilities. However, I do not know the economic impact of such a tax on various segments of the economy. For example, certain protected industries now enjoy unusual breaks now from the tax code. I doubt that they would favor a flat-rate tax. So, I have asked that we make a study of it at Treasury to see if we can come up with some of the economic impact of what such a tax might entail.

Mr. **Crane**. Well, Mr. Secretary, I have had ongoing correspondence with all of your predecessors, going back to Bill Simon in 1975, and with each Secretary of the Treasury since. I have done this to try to get answers to some questions with regard to that flat tax.

For example, if you were to double the personal exemption and then eliminate all deductions in the tax code, what percentage would you have to apply if you just made this flat tax applicable to the personal income tax? Second, what if the same thing were done for corporations as well as individuals, and then, finally, what if all corporate taxes were eliminated and only individuals paid?

The reason I put this question to you is I would very much appreciate—and I have a copy of past correspondence, as I say, going back to 1975 with Bill Simon and on down through 1980. Mr. Blumenthal, for example, when he was Secretary of the Treasury, told me early in 1977 that a 10.4 percent under that first formula would yield the same amount of revenues that we were getting under our complicated tax code. If that is true, I cannot imagine anybody that would view that level of taxation under that formula as inequitable.

It just seems to me that there is a potential for deriving a great deal of additional revenues which today are not being paid. I would like to, if I may, Mr. Chairman, make a unanimous consent request that these questions on these various formulas I might submit to the Secretary. I do not think it would take more than a couple of weeks, would it, to dig out the percentage figures under the three formulas that I just mentioned?

Secretary **Regan**. I would be more than willing to answer those questions for the record. I am not sure of the timeframe, though, on the assumption that we do not want to reinvent the wheel. So we will have to look at these prior studies that have been made in Treasury. Also, I understand there is a new one out by the Hoover Institution that I would like to take a look at on this subject.

I might say in a lighter vein, Mr. Crane, I'm sure that some people would object on the grounds that you might cause massive unemployment in Washington if you went to a flat tax.

Mr. **Crane**. I think one of the obvious virtues of a flat tax is that it does step on some very well-polished toes. I think the chief beneficiaries, however, are the hardworking American taxpayers. And as a result—and I do not claim originality—I mean, Milton Friedman is the author of the idea, like so many other constructive proposals. But, at any rate, I will submit them to you.

I would also, if I may, Mr. Chairman, like to include with this material for the record past correspondence I have had with previous Secretaries of the Treasury and their responses.

[The correspondence referred to follows:]

January 29, 1976

The Honorable William E. Simon
Secretary of the Treasury
Washington, D.C.

Dear Mr. Secretary:

We were most interested in reading your remarks delivered before the Tax Foundation's Annual Dinner on December 3rd entitled "These Three Tax Reforms Can Restore Equity and Confidence in Our System." Like you, we are attracted by the "simple elegance and basic equity" of elimination of all deductions in the personal income tax schedule, and the substitution of a flat tax rate.

We do question whether it is necessary to have a progressive rate if the deductions were removed, and we would appreciate any statistics on revenue estimates you have if a rate of 12 - 14% were imposed, with all other deductions removed. To compensate the low-income taxpayers, the personal exemptions could perhaps be doubled.

We certainly believe that this approach, while controversial, deserves serious consideration. We would appreciate your sending us all the information you have on the subject.

Thank you for your consideration.

Sincerely,

PHILIP M. CRANE
Member of Congress

WILLIAM M. KETCHUM
Member of Congress

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

DEPUTY ASSISTANT SECRETARY

February 9, 1976

Dear Mr. Crane:

For the Secretary, I wish to acknowledge receipt of your letter of February 2 with reference to your letter of January 29, co-signed by Congressman Ketchum, requesting further information regarding proposed proportional taxes, as mentioned in the Secretary's remarks before the Tax Foundation in December.

You will have a further response as soon as possible.

Sincerely yours,

John H. Harper

John H. Harper
Legislative Affairs

The Honorable
Philip M. Crane
House of Representatives
Washington, D.C. 20515

cc: Congressman Ketchum

THE SECRETARY OF THE TREASURY
WASHINGTON

FEB 5 [illegible]

Dear Phil:

I am writing in response to your letter of January 29, 1976, signed jointly with Congressman William Ketchum, as well as to your follow-up letter of February 2, 1976, inquiring about the effect of a broad-based proportional income tax, with a possible doubling of personal exemptions to compensate low-income taxpayers. You also inquired about the tax rate necessary to maintain revenues if the corporate income tax were abolished.

In recent weeks members of my staff have been studying the ramifications of a broad-based tax in some detail, and are continuing to do so. The specific items to be included in such a tax involve matters of judgment as to administrative feasibility, ease of taxpayer compliance and which items are necessary costs of producing income. Personal income, as defined in the national income accounts includes items difficult to attribute to individual taxpayers, such as income of charitable and educational institutions, as well as items such as the rental value of owner-occupied homes, which would be difficult for the average taxpayer to ascertain, especially in a period of rapidly rising prices.

In 1975 adjusted gross income is currently estimated at about $950 billion. For example, to this may be added exclusions such as long-term capital gains and unrealized gains at death, social security and railroad retirement benefits, to the extent they exceed contributions actually paid in by recipients, welfare and food stamp costs, unemployment compensation, veterans' benefits and a variety of other items, including employer contributions to and earnings of private pension funds. This would produce a tax base of about $1,150 billion, which if taxed at a 10.5 percent flat rate would produce the $120.5 billion in individual income taxes estimated for calendar year 1975. There were an estimated 211 million personal exemptions other than for age and blindness, and perhaps 15 million more should be added for persons not now filing returns. Allowing a $1,500 exemption for each of these would reduce the tax base by $339 billion to about $811 billion, so that the breakeven tax rate would be about 14.9 percent.

Corporate income tax liabilities for 1975 are estimated at $39.1 billion, so that combined individual and corporate tax liabilities were about $159.6 billion. The flat rate individual income tax rate necessary to maintain revenues if the corporate tax were abolished would be 13.9 percent without personal exemptions and 19.7 percent if exemptions were doubled; however, if undistributed earnings of corporations were also imputed to individuals these two rates would be somewhat lower.

I trust you will find these comments useful. I am sending Mr. Ketchum a substantially identical reply.

With best regards,

Sincerely yours,

(Signed) Bill

William E. Simon

The Honorable
Philip M. Crane
House of Representatives
Washington, D. C. 20515

PHILIP M. CRANE
MEMBER OF CONGRESS
12TH DISTRICT, ILLINOIS

WAYS AND MEANS COMMITTEE
SUBCOMMITTEES:
HEALTH
SOCIAL SECURITY

Congress of the United States
House of Representatives
Washington, D.C. 20515

OFFICES:
SUITE 1406
LONGWORTH BUILDING
WASHINGTON, D.C. 20515
202/225-3711

SUITE 101
1450 SOUTH NEW WILKE ROAD
ARLINGTON HEIGHTS, ILLINOIS 60005
312/394-0790

November 17, 1975

Congressional Liaison
Department of the Treasury
Washington, D.C. 20220

Dear Sir:

I am writing to request your research assistance on a tax matter.

Given the hypothetical elimination of all corporate taxes, all deductions, the progressive tax schedule and the establishment of a flat rate of taxation; what tax rate would be necessary to equal our current tax income?

I appreciate your assistance on this matter.

Cordially,

Phil Crane

Philip M. Crane, M.C.

PMC/cj

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

AUG 16 1976

Dear Mr. Crane:

This is in reply to your letter of November 17, 1975 requesting an estimate of the flat personal income tax rate which would be necessary to yield current tax revenues if the corporate income tax were eliminated and the progressive tax rate schedule and all deductions under the personal income tax were also eliminated.

To avoid the difficult task of defining an acceptable broad income tax base, a rough but reasonable estimate is made in the attached Treasury staff memorandum using Personal Income in the National Income Accounts as the hypothetical income tax base. The flat rate needed to generate equivalent revenues is estimated to be about 13 percent at 1975 levels.

I am very sorry about the substantial delay in responding. The Treasury has been studying alternative designs of a broad-based tax and their impacts. Response to your letter had been postponed pending completion of the study in order to provide you with a more definitive response about the definition of income as well as the rate estimate. However, current tax legislative responsibilities at the Treasury continue to delay this longer range study. We are providing you with this rough rate estimate but are hopeful to provide you later in the year with a more definitive response.

I hope this is helpful. I am enclosing a copy of your letter.

Sincerely yours,

David F. Bradford
Deputy Assistant Secretary

The Honorable
Philip M. Crane
House of Representatives
Washington, D.C. 20515

Enclosure

August 10, 1976

Treasury Staff Memorandum

Relationship of Federal Government Receipts to Personal Income

Total Federal Government receipts in calendar year 1975--including personal and corporate income taxes, social security taxes, estate taxes, customs, etc.--is 23.32 percent of Personal Income as measured in the National Income Accounts. Calendar year 1975 receipts are estimated by averaging fiscal years 1975 and 1976.

Individual income tax liability for 1975, according to the Treasury individual income model was about $120.2 billion. If the Individual Income tax were replaced by a proportional tax on Personal Income (NIA), the rate required to raise the same revenue in 1975 would have been 9.65 percent. Personal income (NIA) was $1,245.9 billion in calendar year 1975. While Personal Income (NIA) would not necessarily be the most appropriate or the most acceptable tax base (for example, it excludes capital gains but includes the imputed rental income of owner-occupied dwellings), it provides a reasonable base. For comparison, total adjusted gross income on 1975 individual returns is about $950 billion but excludes government transfer income, fringe benefits and many other forms of income.

If the proportional tax on personal income replaced both individual and corporate income taxes, the rate required to raise the same revenue would be 12.94 percent. The year 1975 was an atypical year for corporations and it is too early for an accurate estimate of 1975 net liabilities. A fair approximation is to use the average of net corporate income tax receipts, on a budget basis, for fiscal years 1975 and 1976. This procedure yields a calendar year figure of $41.0 billion. That combined with the individual tax receipts of $120.2 billion represent 12.94 percent of personal income.

Office of the Secretary of the Treasury
Office of Tax Analysis

PHILIP M. CRANE
MEMBER OF CONGRESS
12TH DISTRICT, ILLINOIS

WAYS AND MEANS COMMITTEE

SUBCOMMITTEES:
HEALTH
OVERSIGHT

Congress of the United States
House of Representatives
Washington, D.C. 20515

OFFICES
SUITE 1406
LONGWORTH BUILDING
WASHINGTON, D.C. 20515
202/225-3711

SUITE 101
1450 SOUTH NEW WILKE ROAD
ARLINGTON HEIGHTS, ILLINOIS 60005
312/394-0790

SUITE 308
DEERFIELD SAVINGS AND LOAN BLDG.
747 DEERFIELD ROAD
DEERFIELD, ILLINOIS 60015
312/945-5622

July 18, 1978 HAND DELIVERED

Honorable W. Michael Blumenthal
Secretary of the Treasury
Washington, D.C.

Dear Mr. Blumenthal:

I would appreciate your couresty in providing me with the answers to the following questions no later than the close of business July 25, 1978.

What proportional personal income tax rate would be necessary if we are to produce tax revenues equal to those raised in 1977, under the following conditions:

a) the current personal exemption would be doubled
b) all other personal tax deductions would be eliminated
c) corporations would meet current tax code requirements?

What proportional personal income tax rate would be necessary if we are to produce tax revenues equal to those raised in 1977, under the following conditions:

a) the current personal exemption would be doubled
b) all other personal tax deductions would be eliminated
c) corporations would be treated as an individual under the tax code?

What proportional personal income tax rate would be necessary if we are to produce tax revenues equal to those raised in 1977, under the following conditions:

a) the current personal exemption would be doubled
b) all other personal tax deductions would be eliminated
c) corporate taxes would be eliminated?

Thank you for your prompt assistance.

Cordially,

Phil Crane

Philip M. Crane, M.C.

PMC/mr

THE SECRETARY OF THE TREASURY
WASHINGTON 20220

July 26, 1978

Dear Mr. Crane:

This is in response to your letter of July 18, 1978, concerning the proportional income tax rates necessary to produce tax revenues equal to those raised in 1977, under three sets of conditions.

In each case the current personal exemption is $1,500, and all personal tax deductions including the zero bracket amount are eliminated. Other provisions in the law which were not specified in your letter such as the general tax credit and the earned income credit, are retained. In case one, corporations are taxed as under current law; in case two, corporations are taxed as individuals; and in case three, corporations are not taxed at all. At 1979 levels of income, the proportional individual income tax rate needed to raise revenues equal to those raised by individual and corporate income taxes in 1977 is 10.4 percent in case one, 14.5 percent in case two and 17.1 percent in case three. In succeeding years, these rates will decrease as income increases both in nominal and real terms.

Sincerely,

W. Michael Blumenthal

The Honorable
Philip M. Crane
House of Representatives
Washington, D. C. 20515

PHILIP M. CRANE
MEMBER OF CONGRESS
12TH DISTRICT OF ILLINOIS

WAYS AND MEANS
COMMITTEE

SUBCOMMITTEES:
OVERSIGHT
HEALTH
SOCIAL SECURITY

Congreſs of the United States
House of Representatives
Washington, D.C. 20515

OFFICES:
SUITE 1035
LONGWORTH BUILDING
WASHINGTON, D.C. 20515
202/225-3711

DAVID J. ALLEN
ADMINISTRATIVE ASSISTANT

SUITE 101
1450 SOUTH NEW WILKE ROAD
ARLINGTON HEIGHTS, ILLINOIS 60005
312/394-0790

April 1, 1980

Honorable William Miller
Secretary of the Treasury
Department of the Treasury
Washington, D.C. 20220

Dear Secretary Miller:

I would appreciate your courtesy in providing me with the answers to the following questions no later than the close of business April 25, 1980.

What proportional personal income tax rate would be necessary if we are to produce tax revenues equal to those raised in 1979, under the following conditions:

a) the current personal exemption would be doubled,
b) all other personal tax deductions would be eliminated,
c) corporations would meet current tax code requirements?

What proportional personal income tax rate would be necessary if we are to produce tax revenues equal to those raised in 1979, under the following conditions?

a) the current personal exemption would be doubled,
b) all other personal tax deductions would be eliminated,
c) corporations would be treated as an individual under the tax code?

What proportional personal income tax rate would be necessary if we are to produce tax revenues equal to those raised in 1979, under the folowing conditions:

a) the current personal exemption would be doubled,
b) all other personal tax deductions would be eliminated,
c) corporate taxes would be eliminated?

Thank you for your prompt assistance.

Cordially,

Phil Crane

Philip M. Crane, M.C.

PMC:dob

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

NOV 14 1980

Dear Mr. Crane:

This is in reply to your October 31 letter to Assistant Secretary Godley concerning questions you raised in an earlier letter on personal income tax rates. I regret the delay in replying.

At 1981 levels of income, the proportional individual income tax rate required to raise revenues equal to those raised by the individual and corporation income taxes in 1980 is estimated to be 19 percent if corporate income tax rates are unchanged. If corporations are taxed as individuals, the estimated proportional rate would be 20 percent. If corporations are not taxed at all, the proportional rate on individuals required to raise 1980 individual and corporate income tax revenues is estimated to be 24 percent. In succeeding years, these rates would decline as incomes increase.

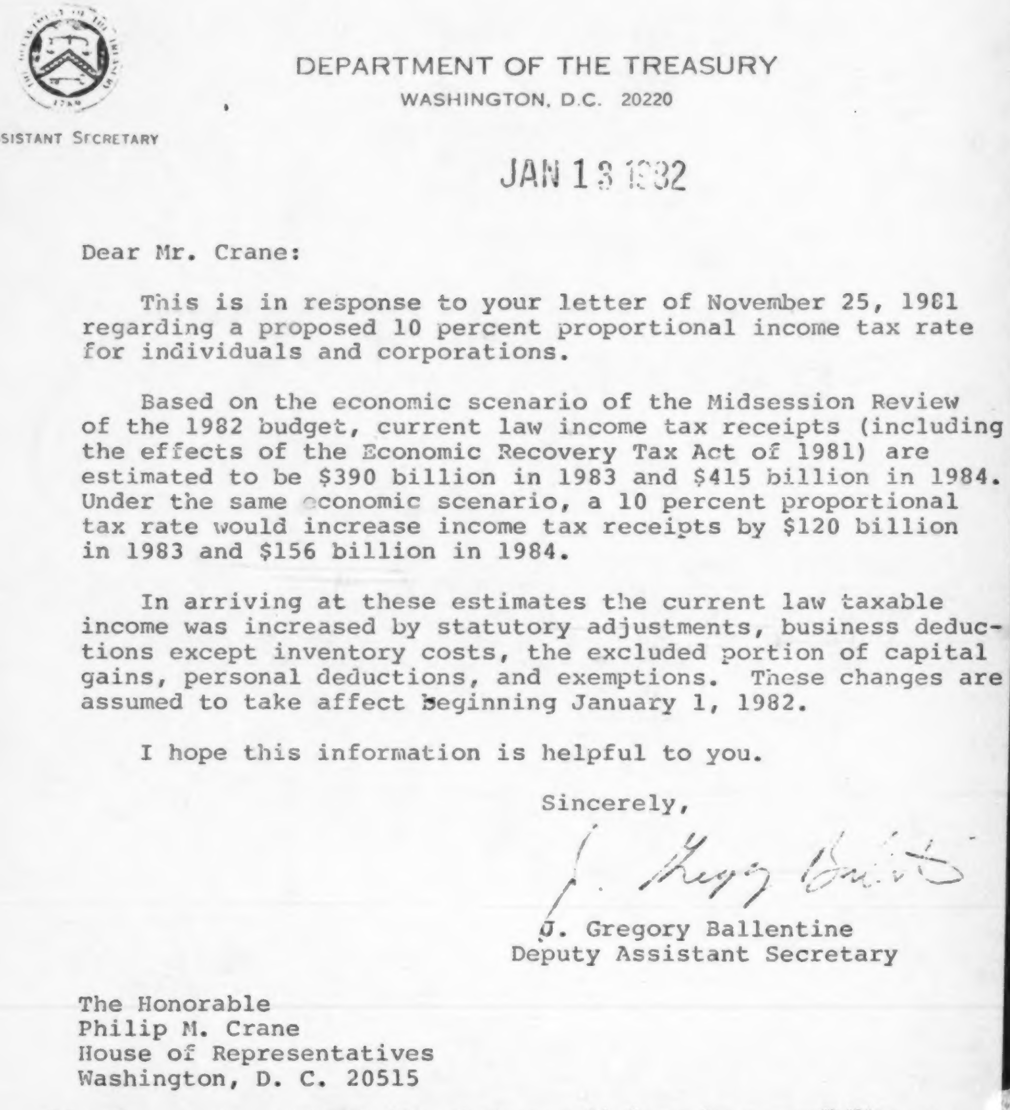
I hope this information is helpful to you. If I may be of any further assistance, please let me know.

Sincerely,

Emil M. Sunley

Emil M. Sunley
Deputy Assistant Secretary
(Tax Policy)

The Honorable
Philip M. Crane
House of Representatives
Washington, D. C. 20515



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

JAN 13 1982

Dear Mr. Crane:

This is in response to your letter of November 25, 1981 regarding a proposed 10 percent proportional income tax rate for individuals and corporations.

Based on the economic scenario of the Midsession Review of the 1982 budget, current law income tax receipts (including the effects of the Economic Recovery Tax Act of 1981) are estimated to be $390 billion in 1983 and $415 billion in 1984. Under the same economic scenario, a 10 percent proportional tax rate would increase income tax receipts by $120 billion in 1983 and $156 billion in 1984.

In arriving at these estimates the current law taxable income was increased by statutory adjustments, business deductions except inventory costs, the excluded portion of capital gains, personal deductions, and exemptions. These changes are assumed to take affect beginning January 1, 1982.

I hope this information is helpful to you.

Sincerely,

J. Gregory Ballentine
Deputy Assistant Secretary

The Honorable
Philip M. Crane
House of Representatives
Washington, D. C. 20515

Mr. CRANE. I would ask the chairman if there is a possibility at some time in the not-too-distant future of holding hearings?

Chairman ROSTENKOWSKI. The Chair is always willing to entertain any measure that simplifies tax collection and simplifies the Internal Revenue Code. When the time is available on the schedule, the committee may be able to hold a hearing.

Mr. CRANE. I thank the chairman for his cooperation. Thank you, Mr. Secretary.

[The following letters were subsequently received:]

[illegible] DISTRICT OF ILLINOIS

WAYS AND MEANS
COMMITTEE

[illegible]
OVERSIGHT
HEALTH
SOCIAL SECURITY

Congress of the United States
House of Representatives
Washington, D.C. 20515

[illegible]
Washington, D.C. 20515

[illegible] ALLEN
ADMINISTRATIVE ASSISTANT

Suite 101
1450 South New Wilke Road
Arlington Heights, Illinois [illegible]
312/394-0790

May 7, 1982

Honorable Donald T. Regan
Secretary of the Treasury
Department of the Treasury
Washington, D.C. 20220

Dear Mr. Secretary:

It was good to see you Wednesday morning before the Ways and Means Committee. Your firm responses to the attacks on the Administration's approach to the Nation's economic woes was appreciated. You did well.

Concerning your comments on a flat rate tax, it was interesting to hear that your predecessors find the concept appealing, if only in retrospect. I am delighted to know of your interest and look forward to further discussion on the matter.

Enclosed are copies of correspondence I have had with Treasury on the flat rate tax concept over the years. They should provide you with additional insight on the degree of my interest. The questions I posed to you on the same subject are also included. I look forward to your response by the end of May.

Kind best wishes.

Cordially,

Phil Crane

Philip M. Crane, M.C.

PMC:jdb

Enclosures

QUESTIONS TO TREASURY SECRETARY REGAN

FROM CONGRESSMAN PHILIP M. CRANE ON MAY 7, 1982

Please Provide for the Record.

What proportional personal income tax rate would be necessary if we are to produce tax revenues equal to those raised in 1981 under the following conditions:

Case 1:
- a) all exclusions, adjustments, and deductions from income, and tax credits would be eliminated;
- b) personal exemptions would be doubled;
- c) corporations would meet current tax code requirements.

Case 2:
- a) all exclusions, adjustments, and deductions from income, and tax credits would be eliminated;
- b) personal exemptions would be doubled;
- c) corporations would be treated as an individual under the tax code.

Case 3:
- a) all exclusions, adjustments, and deductions from income, and tax credits would be eliminated;
- b) personal exemptions would be doubled;
- c) corporate taxes would be eliminated.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

June 2, 1982

Dear Mr. Crane:

This is in response to your letter of May 7, 1982, to Secretary Regan concerning flat tax rates.

In reply to your letter of October 31, 1980, estimates were calculated using a tax base that would include only the adjusted gross income of those who file tax returns under current law. In more recent correspondence, your requests relate to a broader tax base. This summer, the Treasury is undertaking a study to define and quantify a broad income tax base. The final results will not be available until early September 1982. Therefore, I can provide only very preliminary estimates at this time.

In 1983, the proportional tax rate necessary to meet 1981 levels of tax liability for individuals and corporations is approximately 13 percent if the personal exemption amount is doubled and the corporate income tax is not changed from current law. If corporations are taxed as individuals the estimated proportional rate is 14 percent. If corporations are not taxed at all, the required rate is about 16 percent.

I hope this preliminary information is useful to you.

Sincerely,

(signed)
Dennis

W. Dennis Thomas
Assistant Secretary
(Legislative Affairs)

The Honorable
Philip M. Crane
House of Representatives
Washington, D.C. 20515

Chairman **Rostenkowski**. Mr. Downey will inquire.

Mr. **Downey**. Thank you, Mr. Chairman. Mr. Secretary, I would like to continue for a moment the maritime analogy that Mr. Pickle talked about because I have a sense that this is a fiscal *Titanic,* and the only way that this administration is going to change its policies is when it hits an iceberg and goes under.

I would like to know, Mr. Secretary, if your program is working. Are people working more? Are they saving more? And are they investing more?

Secretary **Regan**. At present, as you know, our program has had not much chance to get started. It is like asking a teenager to break the mile mark in running. If you cannot get up to the starting line, it is impossible to break the record.

As you know now from retrospect, when you and I were last engaged in our dialog on the tax cuts last year, we were then in a recession. Neither one of us realized it, and since we started off in a recession, and after that got a lot of increase in the money supply and higher rates of interest, it was impossible to get the thing started with that.

Mr. **Downey**. Mr. Secretary, would it be fair to ask you, then, if your program has not started, are you then also not responsible for the reduction in the inflation rate, if your program has not started?

Secretary **Regan**. I think that the inflation rate coming down is caused by the recession.

Mr. **Downey**. So, when we hear the President and our Republican friends talking about bringing down inflation, in fact, the administration has not brought down inflation. The recession has brought down inflation. Is that a fair statement?

Secretary **Regan**. Well, I think you also have to say that the tight money policy was also instrumental in this, and the fact that we are in a stagnant economy is why we are down there. At the same time, however, if you are not going to allow us to say that, you cannot say that we caused the unemployment, which some of the people on your side of the aisle have charged.

Mr. **Downey**. Well, I just wanted to get us on an equal playing field to find out——

Secretary **Regan**. That would be a novelty.

Mr. **Downey**. If the program has not started, then you cannot claim responsibility for reducing inflation. And I just wanted to make sure that point is made.

Secretary **Regan**. Nor tagged with the high unemployment.

Mr. **Downey**. You have indicated that the administrations would be in favor of modifying the leasing provisions to prevent a company from buying enough investment credits and depreciation deductions to zero its tax liability. Now, Mr. Secretary, in all fairness I think that is just basically a cosmetic change. It would only mean, for instance, that more corporations would be buyers of the benefit. It would not reduce the volume of selling tax benefits, and it would do nothing to prevent the transfer of negative tax rates.

You said something that is very instructive here today. You said the administration believes that nobody should get more than expensing—is that correct—in terms of tax benefits? Are you denying now, and saying to this committee, that you believe that the negative tax rates that are inherent in ACRS and leasing should be done away with?

Secretary **Regan**. No; I am not saying done away with. I think they should be made closer to expensing, is what I said, Mr. Downey.

Mr. **Downey**. Closer?

Secretary **Regan**. Yes, and we have to examine the effect on various industries of trying to achieve that.

Mr. **Downey**. Closer to expensing? But then you are not saying that some companies should not have negative rates of taxation?

Secretary **Regan**. No, not necessarily.

Mr. **Downey**. Some should have negative rates of taxation?

Secretary **Regan**. That is possible.

Mr. **Downey**. Which ones? Can you tell us?

Secretary **Regan**. Well, at this point in time you would have to take a look, for example, at the airlines. What would you do with our airlines? If you do not allow them to have these leasing arrangements in which they can sell their tax benefits, where do they get the cash flow in order to buy new planes? I think there are many distressed industries.

As you know, the air frame industry, as a result of this, is getting a backup on this.

Mr. **Downey**. So, what you believe then, as a matter of policy, is that the industries that are distressed should have negative rates of taxation if they have cash flow problems?

Secretary **Regan**. No; I am not saying that. I am saying you have to take a look at it on an industry-by-industry basis.

Mr. **Downey**. I think that some of us would like to help distressed industries. We would prefer a more precise way to deal with it.

Secretary **Regan**. What would that be, Mr. Downey?

Mr. **Downey**. I think that something like the Reconstruction Finance Corp. that Mr. Rowaytan has talked about or something of that order, Mr. Secretary, would not as promiscuously——

Secretary **Regan**. Bringing back the RFC?

Mr. **Downey**. Let me finish, Mr. Secretary—would not as promiscuously expend capital as the current ACRS method is. But let me ask you a question about——

Secretary **Regan**. How did you arrive at that attitude, Mr. Downey, of promiscuously doing that?

Mr. **Downey**. Well, Mr. Secretary, let me ask you a question about the flat rate tax which you seem to endorse here. In a letter to Mr. Bethune and Mr. Loeffler, Mr. Chapoton and Mr. Glickman said, "The substitution of a flat-rate tax for the present progressive rate system would result in a major redistribution of the tax burden among taxpayers. It would reduce the tax of high-income taxpayers and increase the burden of many low-income taxpayers who now pay little or no income tax."

What is the policy, Mr. Secretary—that it is a good idea or that it is a bad idea?

Secretary **Regan**. There is no policy. As I explained to Mr. Crane in my answer, we are undertaking a study of this at Treasury. As of yet, we have arrived at no policy. Mr. Crane pointed out that previous Secretaries of the Treasury have said that if you up the deductions, you automatically eliminate a lot of the lower income families, and you would probably negate some of the adverse effects of a flat tax in that manner.

Mr. **Downey**. Thank you.

Chairman **Rostenkowski**. Mr. Fowler will inquire.

Mr. **Fowler**. Mr. Secretary, we are down here on the bottom row now. We are the backbenchers who were not privy to these high level negotiations, both Democrats and Republicans. I do not know what was on the table and what was not on the table. I have been trying to listen to these interpretations. But sort of help me think this out, because I am missing something here.

I think that you would agree that we ought not to be looking for a Republican solution or a Democratic solution, but what is the best solution to the economic ills of our country that you have described. What is wrong? Where am I missing? Why doesn't the President of the United States tell everybody—tell all the Members of Congress and the American public—precisely what adjustments that he wishes to make in his budget that he submitted in February to the U.S. Congress, so that we could consider that on the floor of both Houses of Congress and help him bring our country back to economic health?

Secretary **Regan**. Mr. Fowler——

Mr. **Fowler**. Why is there a secret plan which those of us, those of us who ought to know about it if we are to help you vote on this plan, Mr. Secretary, do not know anything about?

Secretary **Regan**. Well, Mr. Fowler, the President tried to make that clear in his television appearance last Thursday night. He described what had been on the table, and as I recall, he pulled from his pocket this sheet, which was the last negotiating sheet that was there. He showed how he tried to get in the middle between what was going on——

Mr. **Fowler**. Mr. Secretary, I do not want to interrupt you, but I think you will agree with me that you have said that he has pulled that off the table. You testified, you told Mr. Rostenkowski that whatever the President put on the table is now off the table.

Secretary **Regan**. Yes, but, Mr. Fowler——

Mr. **Fowler**. I am not interested in what went on in the negotiations. I want to know——

Secretary **Regan**. You just asked me, sir, what did go on.

Mr. **Fowler**. No; I did not.

Secretary **Regan**. You wanted to know——

Mr. **Fowler**. No; I did not.

Secretary **Regan**. I beg your pardon. I misunderstood that.

Mr. **Fowler**. Well, I accept that, but I think I can tell you what I said. I think the record will so show. I said that we were not there, all the rest of us. And what I want to know, my question to you is, why does not the President of the United States, through his chief fiscal officer—the Secretary of the Treasury—and through any other of the Cabinet, come before both Houses of the United States Congress and tell us specifically what revenue raisers he wants us to adopt, and specifically what budget reductions and what programs he wants us to adopt?

Why is he and you not making that public?

Secretary **Regan**. Because, sir, we are negotiating with a mirror. We are being asked to do one thing and then, when we try it, it is rejected. The President did send a budget up here. You have to admit that.

Mr. **Fowler**. I admit that.

Secretary **Regan**. This Congress has not acted on that budget. This Congress has apparently rejected that budget. The President then said, "I will go the next step." He then called for a small group to see if it could be worked out, rather than try to negotiate with 535 separate persons.

Mr. **Fowler**. Since I have just admitted that the President did send a budget with $90 billion deficit—assuming, to get to that $90 billion, $50 billion in budget cuts—and the first chorus of opposition saying, "We shall not accept it," was from Mr. Dole and Mr. Domenici and Mr. Baker—the Republican leaders of the Senate, that said, "we will not support it," and that was in February, within 48 hours after he submitted it.

I do not know how anybody can help you or the President or our country until we receive adjustments in that budget that the leadership of the President's own party has rejected.

You know, I am just trying to figure out a way. By coming over here and refusing to give specifics, we do not have that leadership.

Secretary **Regan**. Well, I think you do have that leadership. We tried. We went through 5 weeks of such negotiations with the heads of the tax writing and the budget committees of the Congress—both Senate and House—and leaders of the administration. And we tried to come out with a compromise budget. In the final analysis, that compromise was rejected.

Mr. **Fowler**. Let me ask you a couple of quick questions. Would you support the repealing of indexing, not in the Tax Code but the indexing of all benefits in our entitlement program?

Secretary **Regan**. The immediate stopping of all indexing? No.

Mr. **Fowler**. The immediate stopping of all indexing and allowing the Congress every year, and the administration, to look at the economic health of the whole country and vote each year how much benefits that we would award?

Secretary **Regan**. That was a suggestion that was put to us by some Democrats. Essentially it was whether we should have something similar to a pay commission; that is, where the pay commission makes a recommendation and the President either accepts it or rejects it, and then he sends his recommendation to the Congress and there is a one-House veto.

That is something that we might want to consider for future years.

Mr. **Fowler**. A last quick question. What is your estimate of the cost of 1 percentage point of unemployment?

Secretary **Regan**. The cost in what manner? Loss of——

Mr. **Fowler**. Revenue loss.

Secretary **Regan**. Revenue loss?

Mr. **Fowler**. Would you agree that it is approximately $25 billion?

Secretary **Regan**. It is approximately $25 billion for each percentage point increase of unemployment.

Mr. **Fowler**. Every time unemployment goes up by 1 percent?

Secretary **Regan**. That is right.

Mr. **Fowler**. Thank you, Mr. Chairman, my time is up.

Chairman **Rostenkowski**. Mr. Gradison will inquire.

Mr. **Gradison**. Thank you, Mr. Chairman. Mr. Chairman, I find myself in the uncomfortable position of not agreeing with very much I have heard from either side this morning. I have difficulty, Mr. Chairman, agreeing with the concept, which I believe you suggested, that it is to the White House that we must look for leadership on this budget question, because I think the responsibility is as great in the Congress as in the White House. I think we need all the leadership we can find wherever we can find it.

I also find myself frustrated not just with knowing how the administration was going to raise that $122 billion, but not knowing how the Democrats who sat at that table would have raised the larger sum that they were discussing. It seems to me that it would be very useful to us in our committee to have those lists or, if there were not lists, alternative strategies from both sides of the gang of 17, Mr. Chairman, so that we could see just what the real choices are.

This is not an argument about whether anything is on the table. This is off the table, but surely there must have been something in the minds of both parties here and I was not at that table. I wish I knew more of what was going on on these points that are the responsibility of the committee.

Mr. Secretary, I do want to thank you for the stress on indexing in your paper, in your testimony. It certainly helped to spell out why many of us feel that the indexing provision in last year's tax bill was the most important long-term change in tax philosophy that we have had in this country in a long time, and why it is essential to keep it.

Would you agree, Mr. Secretary, that in the long run, if indexing were eliminated from the tax bill that the middle and lower brackets would suffer the most?

Secretary **Regan**. Yes, I would agree with that. It is quite evident that indexing will keep the average family, the average $24,000 wage earner family of four, just about even with 1980 by 1986. If we were to eliminate that, he would be paying more taxes in 1985 and 1986 than he had paid in 1979 or 1980.

Mr. **Gradison**. It seems to me that people in the highest brackets got their principal benefit from the drop that has already taken effect from 70 to 50 percent. It seems for people whose tax brackets are less than 50, which is the bulk of the American people, the real hazard in the situation is inflation pushing them up toward—not necessarily to—but pushing them toward that 50-percent level, and that is where the indexing concept becomes very important in the long run.

Mr. Secretary, I want to take a moment to talk about safe harbor leasing. It was my recollection that your February budget assumed an increase of revenue from changes in safe harbor leasing. I am not sure what the number was, but there was an increase in revenue assumed from your recommendations in that area. Is that correct?

Secretary **Regan**. That is correct, Mr. Gradison. Let me get you the exact figure.

Mr. **Gradison**. All right.

Secretary **Regan**. It was a very modest figure for 1983, and it was in the minimum tax component. It was about $0.5 billion.

Mr. **Gradison**. I do not understand how we can pick up revenue from a change in the safe harbor leasing, if what we do is to limit the benefit to any nominal lessor. It seems to me that all we do, then, is require that there be more nominal lessors participating in the marketplace in order to absorb the tax benefits which are being sold by the nominal lessees.

And, therefore, I do not understand how the proposal—and I happen to agree with it and which is alluded to in your testimony this morning—will increase the revenue.

Secretary **Regan**. Well, from the point of view of the fact that if the company that has bought the leases is not going to write down all of its taxes, then you do continue to get that revenue.

Mr. **Gradison**. From that company, sure. But if you are just limiting company A's benefits, I would assume that the net effect is to cause companies B, C, and D to step into the market and take advantage of it. It will just be that somebody else will get that benefit. There will not be the opportunity for carrying it back to previous years or totally eliminating the tax of a current year of the buyers.

Secretary **Regan**. That is possible, but we do not think it is probable, because we think that most of the potential buyers are already in the market. We think that there are few who would have been large buyers, Mr. Gradison, who did not enter that market in 1981.

Mr. **Gradison**. Well, I just want to say that I am not sure you are right about that. I think the market started so quickly that there no doubt were a number of large buyers that did get in very quickly. But my own impression is that there are a number of potential buyers who were a little cautious about this. It was a new idea. They wanted to see how it worked. They wanted to see how the regulations were written.

But also, I believe there is probably a substantial number of moderate or smaller sized buyers out there who, with a more perfected market, would participate. I see great virtue in the safe harbor leasing provisions. I am just a little concerned by assuming we are going to pick up revenues by this kind of adjustment. That is the only reason I raise the question.

Secretary **Regan**. Well, we will try to get back to you and show you how we arrived at that figure.

Mr. **Gradison**. Thank you. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Shannon will inquire.

Mr. **Shannon**. Thank you, Mr. Chairman. Mr. Secretary, I do not want to rehash the negotiations that took place. I do not think there is any purpose in doing that. But you are quite right that we now face the prospect in the Congress of devising a way to reduce these budget deficits, and I think we are in agreement on that fact.

However, the President is also a part of the legislative process. He has the power of a veto. I would like to ask you whether or not the President would veto any bill which included a repeal of the third year of the Kemp-Roth tax cut.

Secretary **Regan**. Mr. Shannon, I do not want to commit the President. He has asked us never to try to forecast what he would do, with or without his veto. I can tell you this. He is adamantly opposed to a repeal of that third year tax cut.

Mr. **Shannon**. Well, you pointed in your testimony to the uncertainty that has been created by this discussion that is going on in the Congress and the uncertainty of investors as to what is going to happen. Assume we came out with a budget proposal that cut the budget substantially and included a repeal of the third year. Would your advice to the President be to veto that bill?

Secretary **Regan**. Well, I will tell you from the point of view of the veto and the like that I would not commit myself on how I would go on anything of that nature. That is too hypothetical for me because I would want to know more of the specifics about where we are. But I can tell you this. In all of our discussions we have consistently said that we do not see why there should be any repeal of the third year.

Literally, we think that the repeal of the third year hurts.

Mr. **Shannon**. I understand that.

Secretary **Regan**. We think it hurts the smaller and average taxpayers.

Mr. **Shannon**. I understand that is your position. But you have an opportunity here today to create a little bit of certainty about this thing. What you seem to be saying is that you are not sure that the President would veto a bill which contained a repeal of the third year.

Secretary **Regan**. No; that is not what I am saying. I am saying I am not going to commit the President on anything regarding a veto. That is his instruction to us. I think some of the uncertainty could be taken out of it today if this committee were to agree today that there would be no repeal of the third year.

Mr. **Shannon**. Well, we are not going to do that, Mr. Secretary, and you know that.

Mr. Secretary, I am a little confused about your own position on indexing because you did give a ringing defense on indexing this morning. Earlier this year in a statement to the press you indicated that the administration might be willing to go along with jettisoning indexing. Last May before the Senate Finance Committee you said:

> The fact remains, however, I am opposed to indexing. I think it is an indication that we are giving in to the inflationary fight. If you index taxes, why don't you index wages? If you index wages, why don't you index prices? You keep going on and on and on. Eventually you end up with an indexed economy which nobody cares about inflation because everything is indexed. That is why consciously I did not want to see indexing in this package.

Have you changed your position on indexing?

Secretary **Regan**. It is now the law of the land, and I am upholding the law of the land.

Mr. **Shannon**. What is your own opinion on it?

Secretary **Regan**. I will go with indexing. I like indexing. [Laughter.]

Mr. **Shannon**. So, are you repudiating your statement of last May before the Finance Committee?

Secretary REGAN. Well, let's say the Congress changed my mind for me when they passed indexing.

Mr. SHANNON. So, we could expect a veto of any bill that repealed indexing?

Secretary REGAN. Again, I repeat that I will not commit the President on vetoing.

Mr. SHANNON. Let me ask you a question about the ACRS situation. In response to Mr. Pickle's question you said that you thought that it was wrong that ACRS was more generous than expensing in some cases. And, of course, that is the point that we on the Democratic side made time and time again last year when depreciation changes were being considered.

If we come up with a plan which would insure that ACRS in no circumstances would be more generous than expensing, can we expect your support on that?

Secretary REGAN. No; as I answered Mr. Downey, I said that I would want to take a look at what you are suggesting and what its effect would be on various industries.

Mr. SHANNON. So, some circumstances where a depreciation will be more generous than expensing, Mr. Secretary, might be acceptable to you?

Secretary REGAN. That is possible.

Mr. SHANNON. Finally, let me ask you a question about this. What if we came up with a plan that said we were not going to have a 15-year writeoff on structures anymore, but move that back to 20 years? Does that offend your——

Secretary REGAN. I think that would be a disaster. With the building trades and others allied with them in their current plight any suggestion to anything that would harm the construction industry or that would take away from them advantages they have been given in the past would be disasterous at this point.

Mr. SHANNON. Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Thank you, Mr. Chairman.

Mr. Secretary, I am a little confused about the purpose of this meeting. When the notice came out, it said that you were going to be here to discuss revisions to the revenue proposals contained in the President's budget, and your statement does not mention that at all.

Do you have no provisions to propose at all?

Secretary REGAN. Well, Mr. Pease, I was invited here by the committee. I did not volunteer. And as you know, this appearance comes at the end of a process that lasted for over 5 weeks, in which there were 17 Members of the House and Senate and the administration engaged in a long discussion of what would happen.

There were many tax proposals that came up during those discussions, some by Democrats, some by Republicans in the House and Senate, and some by the administration. When those negotiations broke off, we have found ourselves back at square one, though we previously sent these things up to the House.

Now, if this committee wishes to discuss further changes in the tax code, we would be more than willing to sit down and discuss them with it.

Mr. **Pease**. Mr. Secretary, is it your position, then, that you have no revisions on behalf of the administration to suggest to the proposals that you sent up here in February?

Secretary **Regan**. Yes. We have no revisions to suggest at this time. As I said before we would be willing to talk with Members of the House and with Members of the Senate about the entire budget and then to see how revenues fit in with that package.

Mr. **Pease**. Mr. Secretary, I would like to go back to the line of questioning that Mr. Gibbons began earlier. The deficit for 1983 was—I think it was agreed upon and mentioned by the President—$182 billion, without drastic action by Congress.

You are saying that you would stand by your original package of $13 billion in tax increases, which would bring that down to $169 billion? And you mentioned something about picking up an additional $5 billion from the underground economy and what the Senate is proposing there. And that gets us down to $164 billion. And then you mentioned $50 billion in outlay reductions, which would get us down to $114 billion.

Is that generally the budget deficit that you are endorsing?

Secretary **Regan**. Well, that correctly states the general nature of where we now stand although we are very anxious to hear what the Members of the House and the Members of the Senate may have in the way of additional cuts in the budget or additional suggestions to us for tax revenue increases.

You see, the point I have been trying to get across is that we keep making these suggestions. They keep getting rejected. And yet, there are no new suggestions coming up, so we find ourselves negotiating with ourselves. That is the mirror I was talking about.

Mr. **Pease**. If in the absence of additional suggestions from Congress, though, you would be willing to settle for a deficit of $114 billion for fiscal year 1983?

Secretary **Regan**. No; we think that would be too high. We think it is up to the Congress to come up with some additional suggestions to get that down further, if at all possible.

Mr. **Pease**. Beyond what you have suggested?

Secretary **Regan**. Yes.

Mr. **Pease**. You are expecting us to do more than you have?

Secretary **Regan**. Yes.

Mr. **Pease**. You are the apostle of outlay cuts.

Secretary **Regan**. Well, why is it that there are no suggestions coming from here? There was a Democratic proposal from the ranking minority member of the Senate Finance Committee. That was really draconian. He wanted to freeze everything.

Now, I do not assume that that is a Democratic proposal, or do I? I mean, in other words, if that is where we start——

Mr. **Pease**. Well, Mr. Secretary, let us look for a minute at the composition of the $50 billion in outlay cuts that you mentioned today. I tried to write them down as you talked about them.

You mentioned defense, $7 billion; nondefense discretionary, $6 billion; entitlements, $6 billion; debt service reductions, $7 billion; management initiatives, $11 billion; user fees, $2 billion. That adds up to $39 billion.

Is there another $11 billion that I missed someplace?

Secretary **Regan**. Did you include the plug figure? My attention was diverted momentarily. Did you include the plug figure for social security?

Mr. **Pease**. No.

Secretary **Regan**. I think you have to plug that figure. I suggested that in an answer to Mr. Pickle, as you recall, that something is going to have to be done in the fiscal 1983 budget. I do not know when, nor do I know how, but something has to be done in order for that fund to remain solvent.

Mr. **Pease**. What is that figure?

Secretary **Regan**. The amount needed depends upon what economic tack you are on, and so forth. But the very minimum would be $7 billion. More likely it should be $12 billion or $18 billion.

Mr. **Pease**. And you are assuming somewhere between $7 billion and $18 billion in cuts in social security as part of your 1983 budget?

Secretary **Regan**. It has to be. I think any budget would have to have that in it.

Mr. **Pease**. Mr. Secretary, one final thing. Three months ago you came before this committee and you said that the economy would come roaring back in the second quarter——

Secretary **Regan**. I do not think I said "roaring back" before this committee. That was before the National Press Club.

Mr. **Pease**. I see. [Laughter.]

Now you say last week that the economy is dead in the water. When will the economy come back, roaring, limping, or otherwise?

Secretary **Regan**. Well, it depends upon what analogy I now want to use, Mr. Pease. But I will say this. We still think that the recovery will be in the second half of 1982, calendar 1982. We think that the economy will come back.

But now, coming from this low base and facing these huge budget deficits with nothing being done about them, the recovery will not be nearly as robust as it should be, although I think it will be there.

Mr. **Pease**. Thank you, Mr. Secretary.

Chairman **Rostenkowski**. Mr. Archer will inquire.

Mr. **Archer**. Mr. Secretary, I personally think, and I think you will agree, it is time for this country to get together. I think it is time for the White House and the Congress to get together and to face the reality of the economic problems that we have.

I do think that it is important—although you may have sort of run around the edges of it—for this country to understand that your original tax proposal was a 10-percent tax reduction retroactive to the first of 1981, and another 10 percent beginning the first of this year. If you had gotten your original proposal, your plan would have been two-thirds in effect right now.

But as the result of the fact that you compromised, we only have a 5-percent reduction today that is available to the American people, instead of a 20-percent reduction. And I think it is very important to state that and perhaps state it over and over and over again, lest there be recriminations and judgments that are not based on the realities of the implementation of your program.

Second, I am reluctant to address this, but because the people on the other side of the aisle have hurled the charge at us so much that we are "the party of the big rich" and that the tax reductions given last year were tilted to benefit the rich. I must say it was not the President that proposed a reduction in the 70-percent tax on unearned income to 50 percent, which is the major part of the bill that helped those in higher income brackets. It was the Democrats on this committee.

In fact, if I remember correctly, it was Mr. Brodhead who was the sponsor of that bill. And I happened to support him. I think it was a good reform, because I do not think the Government should take over 50 percent of anybody's earnings.

But it was only after the Democrats on this committee adopted that proposal in their substitute, Mr. Secretary, that the President incorporated it into his. So I just think that those facts need to be out so that we can get down to the realities and try to solve some of these problems.

I wonder what deficit today would be tolerable to you? What deficit do you think, coming out of the financial community, that the financial community will look at and be able to say, yes, we can now reduce interest rates and we can now get this country moving again?

Secretary **Regan**. First of all, Mr. Archer, I appreciate the statements you just made regarding the history of last year's tax bill.

I think that what the financial community most of all wants to see are deficits that are declining, not deficits that are rising. If you take those working figures that we were using for discussion purposes, the CBO figures, without any policy adjustments, you will notice that they rise. They go from $182 billion to $216 billion to $233 billion.

The financial community wants to see the reverse of that. They want to see the deficit figures coming down: 1984 less than 1983; 1985 less than 1984. I think the starting point has to be, if at all possible, below $100 billion deficit in 1983.

Mr. **Archer**. So you would not really be satisfied unless we got below $100 billion in 1983. I am glad to hear that, because I do not see in my view that there is enough attention to these deficits and what they are doing to the interest rates. If we could cut the interest rates in half, which is where they ought to be today relative to the rate of inflation—they ought to be about half of what they are right now—the cost to the debt service would save this budget over $50 billion.

Secretary **Regan**. That is correct. That is what I was referring to.

Mr. **Archer**. And that is one of the single biggest ways that we can close this deficit. But to get the interest rate reduction we have to take the first step to close the deficit.

Now, I just have some approximate figures on the budget. And the nondiscretionary, the nondefense discretionary spending is only slightly over $100 billion, according to the figures I have. Defense, entitlements—the major item of which is social security—and interest on the debt, all of which have to be paid and are not subject to the appropriations process, involve all but about $100 billion of the proposed budget in 1983.

Now, under those circumstances, unless we are willing to really get after defense and the entitlements programs, we are not going to cut this deficit down, and that is a reality that we have to face as Congressmen and that the administration has to face. And if we are just willing and content to let these interest rates stay up where they are, then it is going to be a Pyrrhic victory for both sides, the Democrats and Republicans, if this economy continues to crater.

I for one am ready to bite the bullet, and frankly, I would like to see a little bit more strength and leadership out of the administration, and certainly I would like to see it on the part of the Democratic leadership in the House, because I think the American people want us to do something. And we are sitting around and sort of fumbling and trying to make the other side go first, because we are afraid of the political backwash.

And Mr. Secretary, I am glad to hear that you are not going to be satisfied with anything more than a $100 billion deficit; that you want it under $100 billion. I frankly think that is too high if we are going to come to grips with the interest rates. If you have another idea as to how to solve the interest rate problems, I would like to hear it.

Secretary **Regan**. The first step, you have already indicated, to get interest rates down is to cut the deficits, and to show action on cutting the deficits and that it is for real. Then I think you will start to see interest rates calm down. And as we then keep inflation down, the real rate of interest will come down to meet the rate of inflation. And I think that, as you say in doing that we will get interest rates down.

But I would like to add a postscript. I think the President is showing tremendous leadership here. He has gone quite a ways from where he was and he has done his utmost to try to get some type of compromise. I do not think that the President can be charged with lack of leadership on this particular issue.

At the moment he has paused to just wait and see. He is still willing to work with the Congress to try to work out a budget, if that is at all possible. But now he wants to see what Congress is saying. Since they said "no" to him on his proposals, he wants to hear theirs.

But he still would like to get a budget, and a budget with a deficit below $100 billion in fiscal year 1983, if at all possible.

Mr. **Archer**. Thank you, Mr. Secretary.

Chairman **Rostenkowski**. Mr. Bailey will inquire.

Mr. **Bailey**. Thank you very much, Mr. Chairman.

Mr. Secretary, we had a dialog when you were before the committee last, concerning the alternative minimum tax and leasing. I want to compliment you here at this hearing on what obviously are some changes in attitude and approach, particularly on alternative minimum tax.

The alternative minimum tax, at least in terms of industries which are marginally profitable, is little more than a penalty tax. And remember, I told you I come from a very highly unionized district, and I have talked to my steelworkers and I have talked to my autoworkers. We talk about investment problems. I would hope that you would continue to moderate your views in that regard.

And I do not want to put you on the spot with it, so I will not ask you to respond.

I would also like to say that I appreciate the comments you have made on leasing. I think there has been an inference or a piece of misinformation floating here today that perhaps there is some connection, of necessity or otherwise, between the transfer mechanism, which leasing is, and negative corporate rates.

There is not. There may be an issue of subsidation in utilization of investment tax credit and accelerated cost recovery for a healthy corporation, Mr. Secretary, which could lead to a subsidy in some property categories, but certainly this is not an issue that involves leasing.

Lastly, I would like to say that perhaps one of the things you should look at with leasing, Mr. Secretary, that we have had criticism on is not only the reduction of the tax liability of a transferee, that is, a purchaser of the benefits, but I would recommend that you look at some possibility of making sure that there is a closer correlation between revenue drain, revenue loss, the actual cost of the benefits, and the transferor, that is, the seller.

Some of the criticisms have been that the discount rate, as you know, is too large. The hopes were that the market would settle out.

Lastly, can you prevail upon Mr. Dole, please, to change his February 19 date, or at least try to do that?

Secretary REGAN. You are right, by the way, on the negative rates and leasing.

Mr. BAILEY. OK, let me ask some questions. I have one very quick one. You mentioned social security and the need for about $7 billion that you foresaw in a matter of a year or so. And you mentioned that, as the Commission works on it, you are thinking about things over the next few weeks.

I take it you are opposed to any use or guarantee of general revenues to help bolster or maintain benefit levels from the fund. Is that your view?

Secretary REGAN. Yes. I think that is a "slippery slope" once you get into general revenue financing and the trust funds are concerned.

Mr. BAILEY. Well, I just want you to know that personally I disagree with you. I think you are not going to have many alternatives.

I would hope that you do not get into a public position or an inflexible position, in that regard, because politics and public opinion being what they are—and they really do run the country—I think you will not find much room to cut benefits. It will not be allowed. And that comes from your Republican friends here, too.

Secretary REGAN. Well, I think that the President will not be speaking out on this issue, waiting instead until he hears from the Commission.

Mr. BAILEY. That is very wise of the President to do that.

Let me also just ask you a hypothetical question. In all honesty, I feel the President really has been doing a lot of posturing and a lot of politicking with this so-called negotiation with the Congress, and we all know the nature of this institution. You have 535 people, you have respective party caucuses, you have very powerful and effective committee chairmen. You have a multitude of ideas.

The Congress is not a monolith. The system is designed to respond to Executive leadership. That is the way the system is designed.

There are many proposals in this Congress that have been offered. There are many alternatives. You can go to any committee and you can look at our calendar, and you will find thousands of ideas. As a matter of fact, the President adopted and modified some ideas that were introduced in this Congress well before he was elected.

What are you going to do when you sit down and do the arithmetic, Mr. Secretary, and you look at what it really says? When you look at the third year tax cut you look at the forecasted deficits when you go out there in the future, along with indexing and the inviolate attitude that the administration is taking toward it, Mr. Secretary, just where are you really going to get the money?

The truth in fact is that you made recommendations. I do not want to pin you down too much. You said there was a recession there that you did not see coming. Well, that is fair.

But the truth in fact is that the economy has not performed as you predicted. The fact is that ACRS is not being utilized as it should be, because the underlying causes of inflation are not being responded to: modernization of plant and equipment and more efficient production of goods and services.

If you will not go into that area, where are you going to get the money? You are caught between a rock and a hard place. Why do you not just admit that and why do we not get to work on something here?

Secretary REGAN. Well, as far as the proposals that were before our negotiating group, we had long lists of things that could be done, apart from the third year cut, Mr. Bailey. Many could raise funds that would be more than the third year tax cut, without getting into the position of saying that the ordinary worker is the guy who should pay for balancing the budget. If you take away that third year tax cut—I hate to keep coming back to this—you are really hurting that type of person. And we think there are other and better ways to increase revenues.

Mr. BAILEY. I am out of time. And that is a very clever political response. We went over that kind of thing with the minimum corporate tax. I am not the least bit afraid of you on that.

But when you start looking at indexing and the impact of the flat tax, the flat bracket change of 10 percent, and if you look at indexing, if indexing were applied without that change, you come up with a different story. It is not a fair way to paraphrase it.

Thank you.

Chairman ROSTENKOWSKI. Mr. Matsui will inquire.

Mr. MATSUI. Thank you, Mr. Chairman.

Secretary Regan, I appreciate your testimony today. One of the things with which I have found difficulty, is the fact that you are saying now that it is really up to the Congress to come up with some proposals. You say that the President made his budget recommendation in February of this year and that by our inaction we basically have rejected his proposal. You said now it is up to us.

What troubles me about this analysis is that the President in his public discussions—and apparently what occurred in the private discussions with the 17 Members of Congress as well—is that he has said: You cannot touch the third year, you cannot touch ACRS, and on defense you cannot touch more than $4 or $5 billion.

It is very difficult to negotiate with that kind of posturing. I do not know how you can really say it is up to Congress now, because we have not been able to negotiate with you because you have excluded about 50 to 60 percent of the possible revenue areas and spending cut areas.

Secretary **Regan**. Well, let us face it, it was the Democrats who took a lot of other things off the table and said: We cannot negotiate with those. So just as much was taken off the table and put into the untouchable area by Democrats as by the President.

Now let us come back to that third-year tax cut for a minute. The President, at the final session with the Speaker and the majority leader of the Senate, as both of them have acknowledged publicly and in the press, actually agreed to change his third year, which was a big step for him. But that was rejected by the Speaker. So you can hardly say that the President's position was set in cement.

Mr. **Matsui**. That is not so. All he did was to suggest delaying that third year for 90 days. And I shall tell you this—and you should know this as you are from Wall Street and have talked to a number of economists—the concern is not just with the delaying the third year. The concern is a total revenue loss over a 3-year period.

And you are talking about $75 billion just on the third year of that tax cut over the next 3 years, and that is a big hunk of the $122 billion or $125 billion you are looking for.

Secretary **Regan**. Yes, but there are other ways to arrive at that. That is what I said in answer to Mr. Pease. There are many ways to get to that without touching that third-year tax cut. The President was agreeable——

Mr. **Matsui**. I understand.

Secretary **Regan** [continuing]. And he changed his position on the third year.

Mr. **Matsui**. Yes, Mr. Secretary. And we would have looked at those alternative ways, but the administration has taken the position that the third year is untouchable, and that is the part that makes it most difficult for us to negotiate.

How can we negotiate if you say that not more than $4 billion or $5 billion can be cut from defense, you cannot touch ACRS, and all we will do is delay the third year by 90 days?

Secretary **Regan**. Well, what is your alternative? What is your plan? Let us hear your plan.

Mr. **Matsui**. Let me tell you something——

Secretary **Regan**. No, wait a minute, please. You are saying we cannot negotiate.

Mr. **Matsui**. That is what I am stating.

Secretary **Regan**. But you are not stating what your plan is. Please tell me your plan.

Mr. **Matsui**. Let me discuss that with you. You know that Democrats in the past have been very reluctant to discuss cutting entitlements. We have been criticized——

Secretary **Regan**. Why are you reluctant to talk about entitlements?

Mr. **Matsui**. Wait a minute. I said this is what we were doing in the past. But we looked at the budget deficit figure——

Secretary **Regan**. Are you willing to talk about entitlements?

Mr. **Matsui**. We are willing to talk about entitlements.

Secretary **Regan**. In what way?

Mr. **Matsui**. I am willing to talk about entitlements. But the fundamental trouble is that your President and our President really does not want to take equal responsibility for these entitlement cuts.

Secretary **Regan**. No, no. We said that if you will talk about entitlements, we will talk about entitlements. This is the first time I have heard you say that the Democrats will talk about entitlements.

Mr. **Matsui**. You know that the Speaker has indicated——

Secretary **Regan**. If that is the case, let us talk about them. What do you want to do about them?

Mr. **Matsui**. You know the Speaker has been willing to talk about entitlements.

Secretary **Regan**. Well, if he is, what is he willing to do about them? We have had no specific——

Mr. **Matsui**. Well, do you want to put the third year of the tax cut on the table, too?

Secretary **Regan**. Well, we will if you will talk about entitlements.

Mr. **Matsui**. You will be willing to do that?

Secretary **Regan**. Yes. That is what I said before. That is what we were trying to do in our negotiations.

Mr. **Matsui**. I am not talking about a delay of 90 days. I am talking about a complete elimination.

Secretary **Regan**. If you will talk about them, we will talk about them.

Mr. **Matsui**. Would you eliminate the third year of the tax cut?

Secretary **Regan**. The third year tax cut? We would talk about it.

Mr. **Matsui**. In other words, you will put it on the negotiating table?

Secretary **Regan**. I beg your pardon?

Mr. **Matsui**. You will put it on the negotiating table?

Secretary **Regan**. We would talk about it.

Mr. **Matsui**. What does that mean?

Secretary **Regan**. Well, what do you mean about entitlements?

Mr. **Matsui**. We would probably——

Secretary **Regan**. Show me the specifics of what you want to do. We have already come up with what we want to do. Let us see what you want to do.

Mr. **Matsui**. Look, your budget in February 1981 was a fraud. Everybody knows it. And that is why you do not want——

Secretary **Regan**. I publicly dispute that charge of fraud. When members of the Cabinet sit around for 3 months going seriously over what and how they can cut the budgets of their individual Departments and very seriously put these proposals to the Congress, I do not think they should be titled fraud. We were very serious in what we did with that budget.

Mr. MATSUI. Well, nobody else took it seriously. So maybe you better talk with your Cabinet.

Secretary REGAN. Well, I suspect that nobody else really took the time to look at it. Go back and take a look at what cuts are there.

Mr. MATSUI. Well, you control the Senate. Why do you not talk with them and explain it to them?

Secretary REGAN. Right now I am talking to the House, and I am asking, what is your suggestion?

Mr. MATSUI. Well, like I said, I think that the Speaker had mentioned and gave a signal before the Easter recess that he was considering reductions in entitlements. And then the President a few days later in one of his many trips—he was boarding a helicopter—said that he was not willing to talk about any reduction in the third year tax cut. And of course, if you are not willing to do that then the entitlements should not be placed on the negotiating table either.

But let me just tell you this, Mr. Secretary. I think everybody here shares the concern that unless this impasse is broken in the next 30 to 60 days or so, you are going to see a lot of false starts and stops. You are going to see a lot of individual appropriation bills get vetoed. You are going to see the financial markets go absolutely crazy.

And we could find ourselves in a much deeper problem than we are in today. And I am very surprised that the President of the United States does not seem to know what the grassroots of America is talking about right now.

Secretary REGAN. The President of the United States is very much aware of what is happening at the grassroots. On March 19 the President of the United States took the first step forward to try to break the impasse, and for 5 weeks we were at it, time and time and time again. He finally took the extra step of coming up here to the Capitol to talk about it, and tried to break the impasse. He volunteered to go in between where the Democrats were and where the Republicans were, and even that was rejected.

Now, how can you say he did not take leadership on something of this nature?

Mr. MATSUI. Well, if you are talking about traveling the first mile, going from the White House to the Capitol, then you are mistaken. It is the only symbolic thing I have seen him do. It is all symbolism. There was really no substance in any of those negotiations.

Secretary REGAN. I was in that meeting and I know what he said, and I know why he did that.

Mr. MATSUI. I want to tell you, Mr. Secretary, I think it is absolutely ludicrous.

Chairman ROSTENKOWSKI. Mr. Duncan will inquire.

Mr. DUNCAN. Thank you, Mr. Chairman.

I want to thank you, Mr. Secretary, for your patience and for the excellent manner in which you have handled the colloquy this morning.

I just happen to have a letter on my desk from a lot of others since the President's speech. I would like to read all of them, but I cannot. But one says he watched our colleague, Mr. Bolling, last week, the so-called answer to the President, but he does not know what he said.

And I was with a group of people the other night, about 300 people, and offered $25 if anyone knew one single suggestion that he made, one specific suggestion to help the situation. And nobody took me up on the proposition.

I think that is about what you asked for today: Name what they would do. And nobody wants to come out.

We received a budget from the President. We have offered nothing in return, and I think it is incumbent upon us.

Let me ask you this: What is the total tax bill for the calendar year, the individual tax bill?

Secretary REGAN. I did not quite get that, Mr. Duncan.

Mr. DUNCAN. What is the total individual income tax liability? What portion of Federal taxes will come from individuals this year?

Secretary REGAN. I think it is just over $200 billion. Hold on a minute. We will try to get that figure for you in just a minute, Mr. Duncan.

Mr. DUNCAN. We hear a lot about that the tax comes from the poor people. But I understand that the top 50 percent of the people pay about 90-some percent of the tax; correct?

Secretary REGAN. Yes; that is correct. I have that broken down if I can just find it. I have some figures here.

The estimate of the individual income taxes for 1982 is $298 billion. That is versus $286 billion approximately in 1981. The total will be $304 billion in 1983.

Mr. DUNCAN. What percentage of that will come from the people with income under, let's say, $12,000?

Secretary REGAN. Under $12,000?

Mr. DUNCAN. Yes.

Secretary REGAN. One minute. You get all of these figures and then in the last minute you cannot find them.

It turns out 2.2 percent of the total is paid by people with less than $10,000 adjusted gross income. From $10,000 to $15,000 it is just under 6 percent, it is 5.9.

Mr. DUNCAN. Do you agree that the interest rate is the biggest albatross around all of us today, around the entire economy?

Secretary REGAN. I would agree completely with that, Mr. Duncan.

Mr. DUNCAN. And what is the interest on the debt this year? I think it should be repeated. I think most of us know it, but approximately?

Secretary REGAN. One minute and I will get the exact figure for you.

Mr. DUNCAN. While they are looking that up, do you think the Federal Reserve and its Chairman have played their proper role as the economy has suffered in this setback?

Secretary REGAN. Well, we have no quarrel with the goals of the Federal Reserve as far as the money growth is concerned.

The interest on the public debt—if I might interrupt—in 1981 was $95.5 billion. It is estimated to be $115.7 billion this year. In 1983 it is estimated at $133 billion, and then it is on up from there.

Mr. Duncan. In past years we assumed we did not have to pay our debts, but we do indeed have to pay our debts?

Secretary Regan. That is for sure. That is untouchable.

As far as the Federal Reserve, coming back to that quickly, we agreed with where they have been going. We are a little disappointed about the manner in which they have carried out their policy because the volatility in the changes in the money supply has put an uncertainty into the money markets that perhaps should not be there.

Mr. Duncan. Are you in contact with the Chairman of the Federal Reserve and trying to get them to change it?

Secretary Regan. They are trying to change it. We are looking at new ways or other ways of accomplishing their purposes at this particular time. I am in contact with them. As a matter of fact, we are on the best of terms. We see eye to eye on most things.

Mr. Duncan. Thank you, Mr. Chairman.

Chairman Rostenkowski. Mr. Stark will inquire.

Mr. Stark. Thank you, Mr. Chairman.

Mr. Secretary, we have been informed that Mr. Stockman was testifying this morning at the Budget Committee. In general, he was requesting the Budget Committee to make the same cuts that were in the February budget proposed by the President.

You are here this morning making essentially the same recommendations that were in the original February proposal in the tax program. So, I think your deficit gets down to around $114 billion. The deficit, if you use the figures in February, was around $126 billion.

So, you are talking both in February and today of deficits of somewhere in the area of $114, $126 billion range. Are those acceptable to you?

Secretary Regan. No. You see, what has happened since February——

Mr. Stark. They are not acceptable to you?

Secretary Regan. They are not acceptable since February. Of course, the economy is getting worse. We are starting from a lower base.

Mr. Stark. I understand that. I am just saying that Mr. Stockman is asking for the same cuts, and you are asking for about the same increases. The economy is getting worse. But you still want to have the completed contract accounting?

Secretary Regan. We wants some changes in that, yes.

Mr. Stark. It seems to hold; is that correct?

Secretary Regan. Yes.

Mr. Stark. And you still want to do away with MODCO?

Secretary Regan. Yes, we want to revise it in some fashion.

Mr. Stark. In the minimum tax, do you still intend the same items in the corporate tax minimum tax?

Secretary Regan. What we have said on that is that we want to work not only with this committee but with the Senate Finance Committee in saying what items should be in there.

Mr. Stark. Do you intend to make the investment tax credit creditable in the minimum tax?

Secretary Regan. We are looking seriously at that proposal.

Mr. **Stark**. That is 80 percent of the minimum tax. So, if you knock that out, you have just reduced your minimum tax. And you are willing to consider that, I take it.

Secretary **Regan**. Yes.

Mr. **Stark**. So what you are really saying is you are willing to eliminate 80 percent of the minimum tax revenue by letting people credit their investment tax credit against it?

Secretary **Regan**. Well, as I said, we would take a look at it and see what other items of preference should go in there.

Mr. **Stark**. You also are holding firm about no bailouts of the savings and loans through the Tax Code.

Secretary **Regan**. Yes.

Mr. **Stark**. All right. You want to help housing, is that correct? You indicated that earlier?

Secretary **Regan**. Yes.

Mr. **Stark**. And you are still going to stick with making the construction period interest be capitalized?

Secretary **Regan**. No, not as far as construction. We have been talking——

Mr. **Stark**. A little change on that one, too?

Secretary **Regan**. Pardon?

Mr. **Stark**. A little change in that one, too, in the construction industry?

Secretary **Regan**. That is possible after discussion.

Mr. **Stark**. Mr. Secretary, I have got to say that you are one of the most highly principled witnesses we have seen here this year. Your major principle is flexibility. That makes it a little easier.

Secretary **Regan**. Well, I would say our administration is flexible.

Mr. **Stark**. It certainly is. [Laughter.]

Do you support—in a fiscal sense, now, not in a philosophical or political sense—but do you think that the tuition tax credit makes good fiscal sense in a time of high deficits?

Secretary **Regan**. Well, I think that has to start off very modestly, considering the condition of the economy and the budget.

Mr. **Stark**. Well, do you intend to recommend excise taxes or increases in excise taxes on alcohol, tobacco, that sort of thing?

Secretary **Regan**. No, we do not.

Mr. **Stark**. And luxury taxes of any kind?

Secretary **Regan**. I beg your pardon?

Mr. **Stark**. Luxury taxes on furs?

Secretary **Regan**. No, we have not recommended that.

Mr. **Stark**. Could I ask you to do this for me. I will make a recommendation. You have asked all of us to do it. Let me pose a hypothetical question since we don't get very far on numbers that hop around here.

Let's assume that you support the constitutional amendment to have a balanced budget, as the President proposed. Correct?

Secretary **Regan**. I do.

Mr. **Stark**. Let's assume that goes into effect this year. It couldn't, but let's assume that we are now talking about 1984. And given your figures and mine, that would mean that next year we cannot spend any more than we take in, and we are probably in round figures, Mr. Secretary—even if we used all your cut recommendations, including entitlements and all of your tax increases—we are going to be $150 billion minimum short in 1984.

So I am going to say, all right, if we do what you want us to do and put through this constitutional amendment, we are $115 billion under water. We have got to cut and we can't do a thing to change that. So I would vote for $50 billion cut in defense, $50 billion increases in taxes, and $50 billion out of all of the entitlements and other things that the Government spends.

Would you support that or would you come back at me now and say: What do you think would be better for the economy of this country than that one-third defense, one-third increase in taxes, and one-third out of the entitlements and other areas?

Secretary REGAN. Well, unfortunately, Mr. Stark, I don't think I can join you in your hypothesis because I don't think it smacks of anything anywhere near reality.

Mr. STARK. You are asking for a constitutional amendment, are you not? That would be the reality, if it passed.

Secretary REGAN. There is no way the constitutional amendment can go into effect. You must remember that when you pass that, it says 2 years after. The amendment says 2 years after it has been passed by three-quarters of the States. Now, 2 years after that——

Mr. STARK. So, really it is just a sham?

Secretary REGAN. There is no way it could go into effect in 1984.

Mr. STARK. So, it is useless to even talk about it now, isn't it?

Secretary REGAN. It is not useless to talk about it, because you ought to pass it.

Mr. STARK. What good would it do?

Secretary REGAN. What good would it do? It would bind future Congresses.

Mr. STARK. Let's assume, then, hypothetically, that it bound us for next year——

Secretary REGAN. We cannot assume that. That is what I am telling you. Our deficits are too high now. We have to be on a glide path down from 1983 to whenever that constitutional amendment goes into effect.

Mr. STARK. So, the amendment will not go into effect until we are even; is what you are saying?

Secretary REGAN. I did not say that, Mr. Stark. You are trying to put words in my mouth. Would you please let me answer your question, sir, without interruption?

Mr. Chairman, can I please answer without interruptions by the gentleman when he asks a question?

Mr. STARK. You could even write us.

Chairman ROSTENKOWSKI. We are looking for answers.

Secretary REGAN. Mr. Chairman, if the proper questions were put, I would give the proper answers.

Now, what I am trying to explain is the reality of the situation. The constitutional amendment, if, as it should be, is passed by this Congress, it will be put to the States. The States will then go on to ratify it. Two years later it goes into effect.

Now, we have 5 years to get to a balanced budget where we are at zero, and then the——

Mr. STARK. Not under your proposals we don't. Your proposals show us $347 billion under water in 1987.

Secretary **Regan**. Mr. Stark, you are interrupting. You don't let me finish. What I am saying is that on the glide path that we have suggested, you do come out to a zero deficit by 1986 or 1987, depending upon the state of the economy in those out years.

Mr. **Stark**. Will you submit that glide path in writing to the committee? We have not seen your proposals for that.

Secretary **Regan**. I positively will.

(The Department of the Treasury later informed the committee that there were no figures available for the "glide path" promised by the Secretary.)

Mr. **Stark**. I would be very interested in seeing that because every budget that you have proposed shows 1987 deficits over $300 billion.

Secretary **Regan**. May I tell you something? If the Democrats had accepted the compromise the President offered just 2 weeks ago—as a matter of fact, last week—we probably could have had a balanced budget by 1986.

Mr. **Stark**. Do you really believe that?

Secretary **Regan**. Yes; because we would be at $35 billion—by figures agreed to by your own members, who were in that negotiation—in 1985. And if you just extend the figures, the deficit falls to zero by 1986. That is why I believe it, I saw the figures. And your people also agreed with them.

Mr. **Stark**. My people didn't agree to anything, as far as I know. I don't know of anybody agreeing to anything.

Secretary **Regan**. Excuse me. They agreed to the working figures. We all agreed on those.

Chairman **Rostenkowski**. Mr. Rangel will inquire.

Mr. **Rangel**. Thank you, Mr. Chairman.

Mr. Secretary, in the budget that was submitted by the administration some time ago, you indicated that the administration had received 95 percent of everything that they had wanted. I assume that there have been some economic changes that you could not foresee, so therefore the deficits were far larger than previously expected.

Secretary **Regan**. That is correct. About $60 billion of the 1983 deficit can be attributed to the decline in gross national product and inflation, and about an additional $30 billion can be attributed to the higher rates of interest on the larger debt.

Mr. **Rangel**. Well, assuming that at the time you had your original recovery package here, you didn't know these things, and now that you do and you are now dealing with new figures what deficit would you foresee if, in fact, the Congress did respond to the budget that is before us? The budget that you have said has been rejected? Originally you were talking about $91 billion and $92 billion, but assuming the Congress adopted everything now that is before it, what deficit would you see project?

Secretary **Regan**. I think it comes out that in 1983—absent any further changes and just going back to the original—somewhere around $115 billion, as I recall.

Mr. **Rangel**. Forgetting the CBO baseline figures, taking what the White House has given us to work with, if we accepted that, then the end results would be unacceptable to the White House?

Secretary **REGAN**. That is the reason we decided we would like to talk to the Congress about further cuts and further changes in the budget, including some revenue increases.

Mr. **RANGEL**. I don't know how you talk with the Congress. The President presents a budget and we either accept it or reject it. But now what you are saying is the budget you have given to us, that if we accepted it, it would be unacceptable to the President?

Secretary **REGAN**. No. What I have said is that——

Mr. **RANGEL**. Let me try it again, then, because I don't want to put words in your mouth.

The deficit that we would get as a result of accepting everything that has been presented to the Congress, the House and Senate and this committee, that if we just accepted everything that you have given us as the Congress did last year, the end result would be a deficit at least $15 billion over what would be acceptable to you—the administration and the President. Is that correct?

Secretary **REGAN**. That is correct, and that is why I suggested that we are willing to talk to the Congress about further cuts.

Mr. **RANGEL**. We are talking now. Assuming that I want to bite the bullet and join with my colleagues and get this behind us to give confidence to the financial world, where they are saying "Why doesn't the Congress move?" I am saying that we are not moving because the President has changed his mind about the budget.

In other words, we have a responsibility to come up with alternatives. If the situation has changed in your projections, how can we accept the political burden when you are not willing to accept what you have presented to us in the first place?

Secretary **REGAN**. Let's put it this way—and again, we will have to go back to a hypothetical situation. I hope mine is a little more realistic—but let's assume that the Congress did this.

Mr. **RANGEL**. Yes?

Secretary **REGAN**. I think at least that would be a start on going somewhere, rather than letting that $182 billion figure just hang out there.

Mr. **RANGEL**. Well, then what you are saying is if we responded to your $115 billion deficit, that you are willing to take some cutbacks in defense, some substantial cuts in nondefense discretionary budgets, and you are willing to raise some type of taxes? Right?

Secretary **REGAN**. That is correct.

Mr. **RANGEL**. And even though you wouldn't be satisfied with that figure, you would then say, well, that is a good start, now the administration would ask you to make further cuts to get under $100 billion. I mean generally that would be the political scenario.

You responded that 1 percent of unemployment is equal, in terms of revenue loss to approximately $25 billion, and certainly, in the projections of the deficit, in the projections of unemployment, even though you got your program, certain things didn't work. Besides saying that you would like to see deeper cuts in spending, my question is, what are you offering now to make up for the adjustments as relates to the increase in unemployment for those people who were not expected to be unemployed?

In other words, you got a $25 billion loss, but are you coming back now and not asking for any cushion for those that got caught in this miscalculation? Are we talking about job retraining? Are we talking about an extension of unemployment compensation? What are we talking about now, when the facts are different than you originally projected?

Secretary **Regan**. Well, as I have discussed in answering questions from other members of the committee, the first thing and the best thing to do is get the deficits down in order to get interest rates down and to get the economy moving again.

Mr. **Rangel**. In terms of the miscalculations that were made when we passed the tax cuts, we hoped that would increase savings that would go into industry and would increase productivity and employment. Since none of those things apparently has happened and unemployment has gone up, now what you are saying is that you want to make further cuts in spending; leaving the tax cuts in place but raising revenue some kind of way.

What you are saying as it relates to those people now unemployed is that the best they can hope for from this administration is an upturn in the economy and that at some point they will be put back to work?

Secretary **Regan**. Now, Mr. Rangel, first of all, you cannot try to tack onto us the charge that we caused the unemployment.

Mr. **Rangel**. No.

Secretary **Regan**. You implied that our program didn't work and that therefore there are higher rates of interest. In my discussions with Mr. Downey, I hoped we had made it clear that if we didn't take credit for disinflation, we wouldn't be tagged with unemployment. You either have it one way or the other. You cannot have it both ways.

Mr. **Rangel**. Let me say, Mr. Secretary, that your program is working. It just happens that a lot of other people are not working. [Laughter.]

As it relates to those people who are unemployed, should we tell them that this program, even though they are displaced, is such, that the best we can do is continue to support the President and that at some point we hope they will be picked up in employment?

Secretary **Regan**. No. I think the first thing the Congress has to do is get the deficit down so that we can get our economy started.

Mr. **Rangel**. OK, I quit. Getting the deficit down is out, and so is an unemployment program for 1982 and 1983.

Secretary **Regan**. Well, as you know, we do have unemployment retraining. We have almost $3 billion in CETA in our proposal.

Mr. **Rangel**. What I was asking, and I hope we can get it on——

Secretary **Regan**. And you know that we also have unemployment insurance as part of our program.

Mr. **Rangel**. You are saying that there is a program——

Secretary **Regan**. You know that we have also asked for the enterprise zones program. There are quite a few things that we have asked for, Mr. Rangel.

Mr. **Rangel**. OK. Well, if you can come into my district and help me explain it, then I think I will be a lot better off.

Secretary **Regan**. I think what people want are jobs, and jobs come from an economy that is thriving. And I think that is the real answer.

Mr. **Rangel**. They don't care where the job comes from. They just haven't got the jobs.

Secretary **Regan**. I understand that. I am very sympathetic to the fact that they don't have jobs. That is why I am here pleading with you to let us get started on this and not just engage in words.

Mr. **Rangel**. Thank you.

Chairman **Rostenkowski**. Mr. Secretary, you want us to get started, but you are only presenting us with your February recommendations. It does not make sense to me.

Secretary **Regan**. Do you have an answer to it, Mr. Chairman?

Chairman **Rostenkowski**. Mr. Secretary, we expect this administration to provide leadership and indicate to us the direction that you want to take. We react to the administration's initiatives. The President is high theater. He is telling the people that there are not any problems in this country. You and I know that there are serious problems.

Until you and I and this committee sit down and start working from real numbers and with a clear direction, which only can be provided by the President of the United States, we will continue to flounder around and keep this fencing match up. Nobody will be satisfied with it. I am getting tired of this, Mr. Secretary.

Secretary **Regan**. For the last 5 weeks, Mr. Chairman, that is exactly what we have been doing under the leadership of the President.

Chairman **Rostenkowski**. Fencing.

Secretary **Regan**. He has given us direction, and you rejected it. Your party rejected what he did.

Chairman **Rostenkowski**. Mr. Secretary, the Congress might just pass your February budget.

Secretary **Regan**. Thank you. I wish you would. At least we would make a start on something.

Chairman **Rostenkowski**. Mr. Moore will inquire.

Mr. **Moore**. Thank you, Mr. Chairman.

Mr. Secretary, I appreciate your being here today, even though it appears to be somewhat rancorous. I appreciate the chairman having this hearing.

I guess that before any meaningful work can be done by this committee on a bill that raises revenue, we need to have one last opportunity to hear from the administration. I think, after having sat here for the hearing, I don't think it has been very helpful, not that it is either side's fault.

It seems to me that I don't guess we could really accomplish anything in a hearing like this today where both sides feel like they have to clear the record or clear the air or whatever in order to see to it that nobody is misunderstood by virtue of the impending elections next November. But somehow from my visits back home I am getting the feeling that the people back home don't really care about our political posturing and political finger-pointing here in Washington. They are just concerned about results.

Mr. Secretary, in all fairness to the President and to you, I think the figures you have given this morning—I kept track of them and added them up—well, my colleagues must have missed their addition or subtraction somewhere. If you start with the $182 billion CBO figure, and if we take your figures of spending cuts and tax increases and COLA changes and debt service changes and interest rate change and defense cuts, it gets you down—at least according to my subtraction—down to about $86.5 billion in a deficit; less than half of what is currently projected.

Mr. Secretary, I think that some members of the committee have not been entirely fair to you and have overlooked parts of your testimony. You have offered a program—you and the President—and it has been rejected. You are correct that it has been rejected. From what I read in the papers, you offered a second one in the negotiations, and that was rejected. I am not sure, if you offered a third one and a fourth one and a fifth one, that that would get anywhere, Mr. Secretary, in terms of it being done in the current atmosphere and being done in the crucible of a political election year.

But I want to congratulate you and the President for trying, anyway. I think you have done that. You said time and time again this morning that you have not received a counteroffer. It is my understanding from contracts that when you make an offer, you expect to receive a counteroffer. I am not aware that you have received one yet, or at least there has not been one publicly that has been offered that I have seen.

I understand your impatience with accusations of no leadership. I must disagree with my distinguished chairman of this committee. I think the Congress has a bigger obligation—and I don't think he meant it that way—of merely reacting to the administration. I think we have the obligation somewhere along the line to come forward in a bipartisan manner, and I hope that we would do that in the coming weeks.

I would hope that when this hearing is over, we could end on both sides the political posturing and that we could try to get down to reducing the deficit. I think that is really the issue.

But I do want to thank you, Mr. Secretary, for being here. I think you have gone the last mile. I think at this point it is going to be up to Members of Congress to try to come up with a counteroffer that hopefully the administration can accept.

Thank you.

Secretary **Regan**. Thank you, Mr. Moore.

Chairman **Rostenkowski**. Mr. Jenkins will inquire.

Mr. **Jenkins**. Thank you, Mr. Chairman.

Mr. Secretary, I am slightly to your left over here and slightly to the right of the chairman, if you don't know where I am as I speak to you.

I think I agree somewhat with what Mr. Moore said, that there has been a great deal of posturing. I understand that. But I have been trying to keep up with the figures also, and they are very difficult for me to follow. I do want to be helpful if I can, within the committee and the Congress, on this crisis that we are in.

First of all, last year when we met, Mr. Secretary, of course we did not anticipate, and you did not anticipate, I am sure, that the administration would have to be coming this year to ask for tax increases; did you?

Secretary **Regan**. No. We said that we would probably be back with some suggestions for changes in the Tax Code. But tax increases to that extent? No.

Mr. **Jenkins**. And because the economy has not responded, now we are in a position that we have to have adjustments in the President's economic plan; is that correct?

Secretary **Regan**. Yes.

Mr. **Jenkins**. Also, as I tried to follow the dialog this morning, what you are saying and I assume what the OMB director is saying, Mr. Secretary, is that at this juncture you are satisfied with the February budget, that you are pushing the February budget as presented by the administration?

Secretary **Regan**. At this juncture; yes.

Mr. **Jenkins**. All right. What I want to get straight in my own mind is, as I understand that budget it asks this committee to raise $13 billion in new revenue.

Secretary **Regan**. That is correct, Mr. Jenkins.

Mr. **Jenkins**. And a total of $49 billion over a 3-year period of time?

Secretary **Regan**. That is correct.

Mr. **Jenkins**. All right.

Now, will the administration be satisfied if this committee raises new revenue of $13 billion and a total of $49 billion over the next 3 years?

Secretary **Regan**. At this juncture; yes.

Mr. **Jenkins**. Well, I want to make sure because I want to help you raise that revenue, but then I don't want to go beyond it, you understand.

Secretary **Regan**. We did say that in addition to that there is a proposal in the Senate Finance Committee—the so-called Dole-Grassley proposal—to attack the underground economy. We would support efforts in that direction. That would probably raise an additional $5 billion or so.

Mr. **Jenkins**. Well, when we talk about that, that is somewhat nebulous. It is like a management figure and savings and so forth. If they come up with something concrete, I will be willing to look at that. But I want to make certain that if this committee raises $13 billion in new revenue for fiscal year 1983 and a total of $49 billion over the next 3 years, that we will have satisfied what the administration wants.

Secretary **Regan**. In light of our budget and the like; yes. In light of the economic situation and the possibility that there should be additional work done by both the administration and the Congress on this budget, we would be willing to talk about going even further.

Mr. **Jenkins**. Well, I know you would be willing to talk about going further, but I want to know what our obligation is as far as taxes. A lot of other committees have other jurisdictions. But I want to make sure that the $13 billion is sufficient and that the $49 billion is sufficient for 3 years, because I am going to support something to raise the $13 billion but I don't want to go a penny beyond what the administration is asking.

Secretary **Regan**. Well, we would be willing to go to $18 billion as just suggested.

Mr. **Jenkins**. You may be willing to go to $18 billion in fiscal 1983? All right.

Now, do you want this committee to enact tuition tax credits for private schools this year?

Secretary **Regan**. I think a modest start could be started on that this year.

Mr. **Jenkins**. How much do you want us——

Secretary **Regan**. I am talking about fiscal year 1983.

Mr. **Jenkins**. How much do you want us to cut in that area?

Secretary **Regan**. I think it is about $30 million.

Mr. **Jenkins**. For fiscal year 1983?

Secretary **Regan**. Yes.

Mr. **Jenkins**. And that is how much you want us to cut? And that will also go up in fiscal 1984 and 1985?

Secretary **Regan**. Yes; it will. It goes up to around $400 million in 1984, and then to around $900 million in 1985.

Mr. **Jenkins**. Does that mean, then, that we have to find room in this budget to make up for that $1 billion or so—the $1.5 billion—over the 3-year period, or can you make that up in fraud or waste or something?

Secretary **Regan**. No. There are other ways that it is possible to make that up.

Mr. **Jenkins**. All right. I know my time is about up. I want to end by saying that I appreciate the support of the administration for the constitutional amendment that Mr. Conable and I have introduced. I frankly believe that if we had had that in effect last year—and you may not like my analogy of this—but I do not believe we would have passed a multiyear tax bill until we were sure that we could have cut on the spending side to make up for that.

Secretary **Regan**. I have no doubt you are right on that.

Mr. **Jenkins**. And incidentally, this constitutional amendment will apply to defense spending just as much as it will apply to entitlements.

Thank you for your support and thank you for your appearance here today.

Chairman **Rostenkowski**. Mr. Guarini will inquire.

Mr. **Guarini**. Mr. Secretary, is the administration still interested in a tax surcharge at all or has that been taken away?

Secretary **Regan**. No; we are not interested in a tax surcharge.

Mr. **Guarini**. You talked about some new ideas. Has the administration ever considered capping the tax cut for individuals, at $700 and $1,400 for next year and the year after, which would not affect people making under $40,000?

Secretary **Regan**. Do you mean a flat tax? I don't understand the question.

Mr. **Guarini**. No. $27.7 billion could be raised in the next 2 years if we capped the tax cut for individuals.

Secretary **Regan**. Oh, capped the tax cut? No; we have never considered that.

Mr. **Guarini**. Would you consider that a valid idea in order to save $27.7 billion?

Secretary **Regan**. No; we would not.

Mr. **Guarini**. You would not?

Secretary **Regan**. We think it would destroy incentive.

Mr. **Guarini**. Do you think that the money that the wealthy would be getting back, if it is not capped, would be going into tax shelters and money market funds, or would it be going into investments to improve productivity?

Secretary **Regan**. Well, to the extent that people have money in their pocket, they can either spend or save it. And it was our projection last year—and I still think they are correct—that about half of the tax cut would be saved and half would be spent.

Mr. **Guarini**. Well, we are now talking about a lot of numbers. And of course you deal in numbers both in your career and as Secretary of the Treasury. It is our job to deal in terms of real people and in terms of the reality of what is happening in the district. I have never had more mail in the past than I have had now with what is happening in the last 12 months and the proposed cuts that are being put on the table. The people out there are hurting.

Let me give you a typical letter. I will ask how you would answer this letter if you were myself. I have a letter that is typical of many letters. It comes from the First Baptist Church. It comes from a minister in Jersey City by the name of Darrell Blake. I just want to read it to you. This is what is happening out in the real world.

The letter reads:

> The other day a woman came to my door asking me for some food. I went with her to her house. She had a husband who was working part time, but who had been partially laid off his job. She had two sons, ages 10 and 12. They lived in a basement apartment of a three-story house, all four of them crowded into two small rooms which had only one window. I said to myself, "I hate poverty," and cried within me for the kind of insensitive society that could let a family that was doing their best suffer like this.

He went on and said:

> I have the capabilities of the clergy to do relief work: that is, meet emergency needs. But I ask, urge, and pray that you will work to achieve a compassionate and just society.

He is asking that we do not create a budget that punishes the poor for being poor. How would you answer that letter, Mr. Secretary?

Secretary **Regan**. Well, has that family applied for help?

Mr. **Guarini**. I beg your pardon?

Secretary **Regan**. I would ask, has that family applied for help, for relief in any type of fashion? I do not know. They certainly sound to me as though they are eligible for food stamp help. There may be aid to families with dependent children assistance available. There may be many things that that family is eligible for. I would have to find out before I answered that letter just what——

Mr. **Guarini**. He said they were not eligible for food stamps.

Secretary **Regan**. It would seem to me that if he is only on part-time, that they certainly would be eligible for food stamps.

Mr. **Guarini**. The main point is that most of the people back home feel that the military spending is preventing us from doing social justice for the people who need it. This is crippling the resolve of our people back home. They see more unemployment and more deficits and they see our Nation going deeper and deeper into debt because of the supply side economics. And there are a lot of predictions of a hot summer in many urban areas of our country.

We have up to 50 percent unemployment among our minority youth, with them standing on street corners and without jobs and having this potential to commit crime. Do we have a national policy for our youth where we can employ them?

Secretary REGAN. We certainly have efforts underway to employ the youth, as you know.

Mr. GUARINI. I have not seen any policy to show that we have such a policy of employing our minorities.

Secretary REGAN. We have CETA. And the CETA programs over the last several years have spent billions trying to train these youths. I can get you the specific statistics on that, but I am sure your staff can get them as easily as I can. But we do have these programs in place.

Mr. GUARINI. Well, I submit they are insufficient. But do we have programs for our large companies that are going bankrupt where many jobs would be lost, such as International Harvester and Pan American and Braniff?

Secretary REGAN. We have no programs to bail out businesses that fail.

Mr. GUARINI. And hundreds of thousands of people, then, will be laid off. We once had a Reconstruction Finance Corporation, but this administration does not want to propose a solution for the bankrupt companies that are employing these people.

Secretary REGAN. You have to ask yourself why these companies go into bankruptcy when there are other companies in the same industry that are surviving. If these are management mistakes and things of that nature, I do not think it is up to us to bail them out.

Mr. GUARINI. Are they surviving in the auto field? Are they surviving in the steel plants of our country, sir? Are they surviving in some of the computer industries?

Secretary REGAN. They are surviving, yes, but just barely. That is why I come back to our point that we have to get this economy going. You said it was supply side economics that caused this. On the supply side, only 1¼ percent of the 25-percent tax cuts have gone into effect so far.

Mr. GUARINI. Well, the reaction of Wall Street does not confirm what you are saying because there is a lot of trepidation out there right now. Those are your colleagues.

Secretary REGAN. Well, they are afraid of the deficits.

Mr. GUARINI. Thank you very much, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Rousselot will inquire.

Mr. ROUSSELOT. Thank you, Mr. Chairman. Mr. Secretary, thank you for being here today. I thank you for your very candid comments and the charts that you provided this committee. I just hope that we all review them.

I would just like to state in the beginning that I was here when we passed the Budget Act of 1974 and I am sure you are aware that the responsibility under the Budget Act is right here in Congress. When we passed that act we did not say that we would sit around and wait forever for a President to recommend. We said that it was our responsibility to start the budget process right here in the Congress, and I think some of my colleagues have forgotten that.

They keep saying, "Well, what has the President to say?" He made his proposals in February. He was willing to modify those, as you have already stated, and yet some of my colleagues have forgotten, even those who voted for it right here, that the total responsibility for the budget resolution is right here in Congress.

We are waiting for our Budget Committee to come up with their proposals for what they want to do on the 1983 budget, and I am sure that they are going to act, hopefully fairly soon. But I think it is interesting to note, Mr. Secretary, that if we took all of the recommendations by the Committees of the House of Representatives, to the Budget Committee the collective spending level recommended by the committees of this House to the Budget Committee for 1983 would be a spending level of $805 billion.

That is a substantial increase over what the President recommended. So, there is a recommendation before the Budget Committee of this House for a spending level of $805 billion. And somehow my colleagues have forgotten that. This committee made recommendations to that Budget Committee and some of my colleagues here have already forgotten what those recommendations were.

So, comparativewise, the recommendation before the Budget Committee on spending is already there and in place by the House—$805 billion of spending as opposed to the President's recommendation of roughly $753 billion. And that deficit would be—by the House majority, including Speaker O'Neill—almost $40 billion more than recommended by the President. I know my colleagues know that, so they are probably going to reflect on that for a few minutes.

Now, Mr. Secretary, we do appreciate your endorsement of the constitutional amendment to balance the budget. Some of us have had such amendments before the House for 10 years, but suddenly there has been new interest in it. I am glad to see my colleagues on the other side now suddenly concerned about deficits. We have had so many born-again people on balanced budgets that it is just refreshing to see so many of them. The only problem is, they have not told us where to save the money on the spending side.

Let me ask a question. In your studies of taxation, how much—and this is in the past or in history—how many times when Congress has raised taxes has that generated more jobs and more everything? Is there much history to prove that by raising taxes—like what is recommended by some of my colleagues on the other side, especially in a recession, that that is helpful to an economy?

Secretary **Regan**. Offhand, I cannot think of any.

Mr. **Rousselot**. Well, I cannot either. I just wondered if you heard it. Maybe we are missing it. Some of my colleagues say, "We must increase taxes." Of course, they have always believed in that—many people on the other side of the aisle—that raising taxes and spending does everything for the country.

But I just wondered if there is any history to show that. You cannot find any?

Secretary **Regan**. I know of none offhand. I would be happy to try to look and see if we can find any.

Mr. **Rousselot**. I searched and I cannot find that any place. A lot of times in wartimes we have raised taxes to pay for our defense and the military and so forth. But I just do not find that that is helpful to an economy to raise taxes, especially even projected into the future.

Secretary Regan. Well, you will recall that in my prepared remarks I said that over the period of 1977 to 1981 we increased taxes—due to bracket creep, primarily inflation—by $244 billion. And at the same time came up with deficits of $194 billion.

Mr. Rousselot. Oh, did we do that here in Congress? Gracious, that is right. We are responsible. We do have to pass the appropriation bills. I do remember that.

Well, thank you, Mr. Chairman. I went over my time.

Chairman Rostenkowski. Mr. Heftel will inquire.

Mr. Heftel. Thank you, Mr. Chairman. Mr. Secretary, I think that we both know that all of the rhetoric and all of the showmanship in the world are not going to change the size of the deficit. And in communicating with my constituents back home the only way I have been able to explain how we reduce the deficits is by talking about specifics. The only ones I have been able to focus on that make any sense—because of size and because of capacity to reduce the budget—are entitlement programs. I have tried to tell my constituents that you cannot automatically increase Federal wages and benefits.

I tell them that you have to tie what you pay out of the Federal Government to those who are workers or beneficiaries, Mr. Secretary, to the status of the health of the Federal treasury. That military spending—the increases that have been proposed—must be curtailed, not because we should or should not have them, but because we cannot afford them. We certainly cannot afford them now.

I have said that we have to hold in abeyance, until the economy permits, the 3-year tax cut. I have said that we must have adjustments to ACRS. And I have said that we have to have some other major form of income if we are going to achieve anything that looks like an under $100 billion deficit. And the simplest one that I could come up with was a Btu or an energy tax.

Doing those things could bring the deficit down to about $85 billion. My contention was that that was the best way to help the American people, because that was the only way you could bring down interest rates. And unless we bring down interest rates, nothing else makes any sense. All the tax incentives in the world will not change the decisions of business when they look at the uncertainties of interest rates.

I am wondering if the President and yourself, the majority party in the Senate, the minority party in the House, are going to face the simple and hard facts and present a budget—something under $90 billion of deficit—that does the things you have to do, including taking the political heat that goes with it. Because there is no solution that will meet the challenge of reducing those deficits, Mr. Secretary, that does not involve political discomfort between now and November. And I see no signs that either my side of the aisle or your side of the aisle is ready to take those painful measures in the best interest of the economy and the nation and the people.

I am just wondering if you think you are going to finesse the problems we face until November or are you going to take those kinds of specific and meaningful steps?

Secretary Regan. Mr. Heftel, I think that this administration and this Congress can and should get together to settle this deficit question. We do have an ideological or a political or a philosophical difference as to how to do so.

On one side people are saying that we should not cut spending as much as the other side is saying. That same side is saying that we should raise taxes more than the other side is saying. Somewhere in between there has to be a compromise.

We tried for 5 weeks to reach that. We thought we were fairly close, but we got stuck on some of these very tough nuts. We threw it to the principals. They, too, were unable to resolve the differences. We are going through a current phase of what you might call rhetoric or posturing or getting it off our chests or whatever because of the frustrations we may have due to breakdown of the negotiations and the fact that we now seem to be at a stalemate.

Nevertheless, I have always been more on the optimistic or, if you will pardon the expression, "the bullish side." I think we can come together on this when this period of rhetoric has passed. I think the sooner it passes, the better. And I think that we can come together on where the spending cuts should be made and where additional tax revenues should come from, given that these are the only ways available to get these deficits down.

Mr. **Heftel**. Mr. Secretary, do you think it makes sense for you and for your administration to sit down with the majority, which you possess in the Senate, and to develop a budget that makes some kind of sense where your original budget unfortunately did not? I am not saying that developing a new budget would reflect a lack of credibility or ability on the part of the administration.

Let us just say that conditions have changed and that their crystal ball did not tell the administration what was going to happen. A lot of us who had crystal balls and said what we thought was going to happen, and it was exactly what we said. But, nonetheless, don't you think at the very least you have an obligation to sit down with that majority in the Senate and come up with a proposal which is supported by both the administration and the Senate?

Secretary **Regan**. We could have the budget process originate in the Senate and then sent over to the House. We think we can work with both sides of the Hill.

Mr. **Heftel**. But am I not correct, though, that you must work with your majority in the Senate, so that the country and the House know that at least the Senate and the President have a point of agreement?

Secretary **Regan**. Well, I think that that is what we are attempting to do right now. As you know, the Senate is in markup right now on a budget. We are working with them on that to see what can come out of it.

Mr. **Heftel**. Thank you.

Chairman **Rostenkowski**. The Chair notes that the Secretary has to leave at approximately 10 minutes after 1. So, it is the chairman's obligation to see that the Secretary concludes by then and takes that mile ride down to the White House.

Secretary **Regan**. Thank you, Mr. Chairman, for that consideration.

Chairman **Rostenkowski**. Mr. Hance will inquire.

Mr. **Hance**. Mr. Secretary, it is always good to see you. I appreciate your testimony. I have a couple of questions and suggestions.

On the issue of entitlements and automatic cost-of-living adjustments, it is apparent that the Democrats and the Republicans and the White House are like three people in a building that is on fire. All three are afraid to say "fire" because they are afraid the other two will point at them and say, "You must have started the fire."

I think the only leadership on this issue can come from the White House, and one thing that you said that certainly bears some credibility is that we need to make some suggestions to you. Your budget is not going to pass, and so we ought to suggest some things. I have a suggestion for you.

Would you be willing to look at and consider a 3 to 6-month delay in the tax cut in 1983 in exchange for a cap of 3 or 4 percent on all entitlement programs for the next 5 years?

Secretary REGAN. I think we would take a look at that if accompanied with other appropriate measures. The President said last Wednesday, when he was up here on Capitol Hill, that he was willing to look at a 90-day slip on the last phase of the 3-year tax cut program.

Mr. HANCE. What about the entitlements?

Secretary REGAN. At the same time, he asked if we could not take a look at those, but that was rejected. But I think that we would be more than willing to see if there might be some agreement on the tax and entitlement programs—a bipartisan agreement.

Mr. HANCE. The President ran as a conservative and was elected as one. The public knows that interest rates are not going to come down and the deficit is not going to be addressed until we get some leadership on the entitlements issue.

There are a lot of us who believe that the President would get a lot of support on this issue if he would only take the lead on it. But he has to be the one to belly up to the bar and say, "I am willing to do this. I am willing to address this issue." I would hope that you would encourage him to do so because I think he is getting advice from his aides not to tackle this issue.

But I really believe the public understands it. I hope you will keep this option open.

Secretary REGAN. I will carry the message.

Mr. HANCE. Thank you very much. I will yield back the balance of my time.

Chairman ROSTENKOWSKI. Mr. Anthony will inquire.

Mr. ANTHONY. Thank you, Mr. Chairman. Mr. Secretary, my thanks for your testimony and also my welcome. I would like to follow up on a line of questioning that Mr. Stark was pursuing, and that was the 13 revenue enhancement measures that we have already been holding hearings on.

You indicated there was some give or some rethinking in some of the proposals that had originally been offered. I understand he asked about the completed contract method. I think you also said something about the ITC and the minimum corporate tax.

One thing that I am very concerned about, coming from the State of Arkansas, is the small issue industrial development bonds and I am concerned about what I consider to be a very, very drastic proposal that the administration has submitted to the Congress. Have you had an opportunity to rethink that?

Secretary **Regan**. Well, what we are looking at there is to see what exemptions we can give for small businesses. We are also taking a look at the appropriate treatment of the large corporation getting ACRS and also getting tax-free loans from municipalities—not tax-free loans, but lower rates of interest as the result of tax-free borrowings.

What we are saying on that is that we would like to see is an either/or situation—either the corporation uses ACRS or forgoes the industrial revenue bond subsidy. We think that either one would be fair, but that it is not fair for some companies to double dip and get both. If we can work out something along that line on industrial revenue bonds, we are more than willing to work with you and this committee on that.

Mr. **Anthony**. Well, I would ask you publicly to be willing to work at least with this one Member because I can tell you that if your proposal goes through, you are going to see economic development just come to a complete halt in the State of Arkansas. We are struggling as it is, Mr. Secretary.

I have one little town that has had 1,500 employees laid off from one company and 230 from another company just recently through what I consider to be the proper way out of this whole thing. Just recently we put together a partnership with private enterprise—they put in some money—and the Federal Government put in some money from one of the Federal grant programs that is still alive—and that money from the Federal Government really triggered the whole thing because the company could not have afforded to do this otherwise.

This is in the timber-related industry, in which we are in our 41st month of a recession. Then the city passed a small issue industrial development bond. Although this is a major national corporation, it is only going to provide 87 jobs. And I will tell you what. There was almost rejoicing in the streets because they have a 25-percent unemployment rate in that town.

And, see, just 87 jobs—well, the telephones started ringing, and the mayor said that the folks wanted to start lining up for the jobs. We would not have been able to get that kind of job-productive capacity in Arkansas if your proposal passes.

So, I would just say please, please, please work with us because if this goes through, you just might as well zip us up and write us off.

Secretary **Regan**. We are more than willing to work with you on that. As long as the community is willing to put up a little money, we say, "Good luck. We will go right along with the industrial revenue bond." And you suggested in what you just said that there was some money put up by the local government.

Mr. **Anthony**. Yes.

Secretary **Regan**. As long as that occurs, we are willing to go along with the industrial revenue bond.

Mr. **Anthony**. I think that is a proper way to do it. I am only saying that from a close study of what your proposal is, please take a new look at it. I will submit you some data. I think most recent studies show that we are getting a dollar return for 15 cents in cost to the Treasury. That is at a time when unemployment is the greatest problem in the Nation.

I just want to close with giving you a recent poll that was conducted in Arkansas immediately after the President made his speech. Eighty percent of the people in my district said that they thought that defense spending was too much and ought to be reduced. They said that unemployment was the greatest problem and please do not do anything that would hurt employment. Please do something that would help reduce unemployment.

And, surprisingly, 65 percent of the people said they did not feel like it would be against the President's economic recovery program if the third-year tax cut was postponed, if the additional revenue was not going to additional spending but if it went to reducing the deficit.

So, I would say, in returning to what Mr. Matsui said, that maybe the President should listen to the grassroots. And the grassroots in Arkansas is telling him right now that maybe his position ought to be reexamined.

Chairman ROSTENKOWSKI. Mr. Russo will inquire.

Mr. RUSSO. Thank you very much, Mr. Chairman. Mr. Secretary, as I understand it—and I believe it was brought home very significantly last year—the White House is controlled by the Republican Party, the Senate is controlled by the Republican Party, and the House of Representatives, when you take all 192 Republicans and add 26 or more Democrats, that that particular side of the aisle controls the House of Representatives.

I find my colleague from California's comments distressing because I do not understand why you just cannot pass the 1983 fiscal budget that the President has put forward. Considering what you accomplished last year—and the numbers that you have this year are no different than they were then—why is it that the Republican Senate has not marked it up already and moved it out and put the heat on the Democrats in the House of Representatives?

Secretary REGAN. I cannot answer that specifically for you. I suggest that that would have to be referred to the chairman of the Budget Committee of the Senate. At the same time, I would remind you that what we tried to do in getting a compromise—and most things have been on hold for the last 5 or 6 weeks while we went through this compromise endeavor—was an attempt to avoid the wrangling and bitterness that came out of last year's struggle.

You and I both recall the anguish that all of us went through during that episode, in order to get the votes of those 26 Democrats, and to get our bill passed in this House. We were trying to avoid a repeat of that this year.

Mr. RUSSO. I think the real answer to my question, Mr. Secretary, is that this year you do not have the votes, but last year you did.

Secretary REGAN. That remains to be seen, Mr. Russo.

Mr. RUSSO. Well, as regarding your fiscal 1983 budget I think it has already been made clear that the Republican Senate is not willing to take it up, from what I understand. Otherwise, I suspect that they would have moved it out by now.

I think part of the bitterness that exists was produced because of the way the administration handled the budget process last year when we adopted the omnibus reconciliation bill. The targets were set and were given to the committees. The committees came back and met the targets, but changed the way the spending was allocated. And then a new budget was prepared at OMB the night before. It was very distasteful for a lot of Members of Congress—both Democrats and Republicans—to have a budget document that nobody saw until that morning. You can understand why there are problems with both the Democrats and Republicans.

Mr. Secretary, if we take the fiscal 1983 budget the President sent to the Congress, we are talking about a budget of $757 billion, I believe. And in defense we are talking about $221 billion. In foreign aid it is $12 billion. Space is $6 billion. Energy is $4 billion. Agriculture is $4.5 billion. Highways are $8.3 billion. Education is $13 billion.

Medicare and medicaid is $72 billion. Social security is $173.5 billion. Other retirement and disability benefits are $23 billion. Unemployment compensation is $22 billion. Veterans benefits are $24 billion. And the interest on the debt is $96 billion.

If you add all of that up, it is $682 billion of that budget. Where do you suggest we get the reduction? Could you give me those figures? Where do you suggest we get the reduction to bring the budget deficit to below $100 billion?

Secretary REGAN. Well, in answer to previous questions, I suggested that we could have some management initiatives which would include, among other things, the sale of U.S. lands, offshore leases, and the like. That probably—I think both sides of the aisle agreed during our recent discussions on this—would bring in $11 billion. And then we had user's fees of $2 billion. We had a Federal pay cap in there.

Mr. RUSSO. Mr. Secretary, my problem is that that is $681 billion of a budget that we are unlikely to significantly touch, from what I understand. The parts that the President talks about cutting—food stamps, SSI, AFDC—that amounts to about $28.5 billion. How can we possibly get even close, when $681 billion are essentially off limits?

Secretary REGAN. I did not say that defense was off limits.

Mr. RUSSO. Pardon?

Secretary REGAN. We did not say that defense was off limits. You are the one that said that defense was off limits. I have never said that. I said that the President agreed——

Mr. RUSSO. This is his budget. I am only talking about his 1983 budget. I would assume that——

Secretary REGAN. You asked how we could cut that budget further, if I understand what you are suggesting. I said that one of the areas we had suggested was defense. We also said nondefense discretionary spending.

Mr. RUSSO. $66 billion.

Secretary REGAN. Pardon?

Mr. RUSSO. Nondefense, at the most, is $66 billion. If you add up all nondefense discretionaries, it is about $66 billion, which is 9 percent of the budget.

Secretary REGAN. And we said that there were about $6 billion in cuts that could be made there. There are about $7 billion to $8 billion of possible cuts in defense.

Mr. RUSSO. Mr. Secretary, let me stop you right there. When you talk about $6 billion to $8 billion in cuts in defense, that is not an actual, true statement in the sense that we refer to as "cuts," because as you know you asked for an increase of $33 billion over last year. So, when you talk about cutting $7 billion or $8 billion, you are just talking about cutting the increase in defense. Isn't that correct?

Secretary **Regan**. It is the same thing with entitlements. Entitlements will be more this year than they were last year.

Mr. **Russo**. We cut the domestic side last year by about $40 billion, as I understand, and so we are starting with a reduced figure from last year, whereas last year we started from a higher figure in defense.

Secretary **Regan**. Now you see why we broke apart over the last 5 weeks, because what you are saying is not new. That is exactly the argument. And there is where we——

Mr. **Russo**. I just want to make one last comment on the President's statement on a constitutional amendment. I can understand why the President would want a constitutional amendment based on his projected outyear deficits of $1.2 trillion over the next 5 years. But is it not true that the President has the power today to submit us a balanced budget if he wanted to?

I mean, he could compose a budget document that provides for a balanced budget. It raises revenues and cuts spending. He could give us that. He does not have to wait for a constitutional amendment. Based on his own authority as Chief Executive of this country, doesn't he have the right to propose a balanced budget this year?

Secretary **Regan**. Well, I think that no matter what economic philosophy you pursue, to suggest a balanced budget in the middle of a recession would be counterproductive.

Mr. **Russo**. But can't the President, if he looked at these numbers, propose a balanced budget to the Congress this year or even next year if he wanted?

Secretary **Regan**. Well, theoretically he could. But I do not see what the advantage of that would be when everybody knows that that would be the worst thing in the world for the economy.

Chairman **Rostenkowski**. Mr. Holland will inquire.

Mr. **Holland**. Thank you, Mr. Chairman. Mr. Secretary, I appreciate your statement today. I think I understand some of your problems. I am not seeking reelection this year, and so I do not have anything political to say to you. I have wondered, though, in an administration that bills itself as being endowed with great political courage, why some real meaningful solutions have not been offered for some of these problems.

For instance, I am advised that the administration can do something about entitlements without congressional action. I realize there is some political heat involved in what I am about to suggest, but I know this administration would not shirk from that political heat that may generate itself in 1982.

Why don't you do something about the Consumer Price Index?

Secretary **Regan**. In what fashion, Mr. Holland?

Mr. **Holland**. Well, I think you have seen and I have seen—and I have heard the allegations over the years—that the Consumer Price Index and some of the assumptions made in it are not valid. I read a study recently that said that when true inflation is about

7.7 percent, the CPI will show 12.5. That is a rather serious variance. It seems to me that if you want to talk about entitlements and do something about it, then you can take up the political courage and do that.

Secretary **Regan**. Well, as far as the CPI is concerned, you know, we are going to change that as of the first of January 1983. At that time, a newly computed CPI comes into effect. It has been the old CPI, X-1. It is now the CPI-U, and that is going into effect on January 1, 1983.

So, we will have a new CPI starting next year.

Mr. **Holland**. Well, have you calculated the impact of those changes, which I do not know in detail? If you say those changes are coming, I will accept that. What would be the impact on the outlays and entitlements?

Secretary **Regan**. At present, I think the CPI-U is running just ahead of the current CPI. The reason for that is the amount attributable to the rental equivalent that it includes. Whether you are a home buyer or a renter, it has a rental equivalent factor, and I do not think that factor is quite as large in the new CPI-U.

Accordingly, it seems to be more realistic. It will help to keep down some of the overruns that have been going into the COLA's as a result of the impreciseness of the original CPI in a period of inflation.

Mr. **Holland**. Well, I take it, then, that the reductions in outlays will be dramatic?

Secretary **Regan**. I am not sure they will be dramatic, but they certainly will be cut back.

Mr. **Holland**. Don't you think it is time to stand for something dramatic, Mr. Secretary?

Secretary **Regan**. Well, again, I wish I could assure you that statisticians and economists are very precise in what they are doing in using forecasting tools. But we have all come to realize that these are imprecise measures and the Bureau of Labor Statistics has been experimenting with this particular CPI for many years. They now think it is ready to go into effect.

They are working with other experimental models. I would not want to jump from one to the other until I was certain as to which one was better.

Mr. **Holland**. I see. You want revenue suggestions. I have introduced a bill to tax insurance companies another $1 billion a year for the next couple of years. That industry has been forthcoming. It supports that bill to bring a little order out of a chaotic situation. You are aware of that?

Secretary **Regan**. Yes. That concerns the modified coinsurance provisions and we definitely support changes in that area.

Mr. **Holland**. I have not had any indication from your department that they support my legislation.

Secretary **Regan**. I am not sure of your particular legislation. I will be glad to look into it. But we do support efforts in this area to raise additional funds in the insurance area.

Mr. **Holland**. I would say that if every other member of this committee could come up with $1 billion, we would be on the right road. So, that is my $1 billion for today. And the other few billions I want to talk about is that you say Mr. Grassley has a $5 billion solution to the underground economy which, as you know, is somewhere around a $90 billion annual problem. That solution appears to me to be somewhat inadequate to a very serious problem. I know that we can do better.

By way of dramatic innovation, I wonder if this administration has ever talked about—or is it too politically hot—about the value-added tax?

Secretary **REGAN**. Well, I would refer you to the former chairman of the committee for an evaluation of that one.

Mr. **HOLLAND**. I am voluntarily going where he went otherwise. And I am sure that this administration could be at least as statesmanlike as that and give it some consideration because, as you know, the underground economy could be the difference between a balanced budget or not in the future. And I think it is time for some serious thought on that.

Secretary **REGAN**. I am not sure I can promise you we will look at a value-added tax this year, Mr. Holland.

Mr. **HOLLAND**. It would be a drastic change in philosophy, though. You know, this country taxes productivity, and to change it over to taxing——

Secretary **REGAN**. I think we can get at much of the underground economy by further withholding, but I understand that that is not politically feasible.

Mr. **HOLLAND**. The universal withholding on independent contractors and taxing fringe benefits? All of those items I presume will be——

Secretary **REGAN**. I suspect that much of that will be in the Dole-Grassley bill.

Mr. **HOLLAND**. Thank you.

Chairman **ROSTENKOWSKI**. Mr. Jacobs will inquire.

Mr. **JACOBS**. Mr. Secretary, Mr. Stark a moment ago said something about a $50 billion cut in the Pentagon's budget. I detected a condescension toward that figure. I personally would hold the view that within your military budget there is at least $50 billion of quite literally, Mr. Secretary, nondefense spending.

I wanted to ask you, what is wrong with a constitutional amendment requiring a balanced budget?

Secretary **REGAN**. What is wrong with it? We do not see anything wrong with a constitutional amendment to balance the budget.

Mr. **JACOBS**. Then why have you opposed it until only a week or two ago?

Secretary **REGAN**. To my knowledge, the President had not taken a position—and he takes the position for the administration—until the Cabinet Council on Economics made a thorough study of the proposal and came back with a recommendation to him. Just last week he finally came to his conclusion.

Mr. **JACOBS**. How could he come to a different conclusion if he had not come to a conclusion to oppose it before?

Secretary **REGAN**. Well, you will recall that during his campaign of 1980 he spoke in favor of such an amendment.

Mr. **JACOBS**. Yes; I remember that very well. In fact, I am the sponsor of the oldest standing constitutional amendment proposal along that line. And I wrote to the President within 50 hours after he was elected to the Presidency. I asked him if he would not come out in support of that proposal. I received a letter from the transition team saying I would receive a letter from the President after he took office.

Shortly after he took office, I received a letter from one of his aides saying I would receive a letter from the President within the next 10 days. I have not received a letter yet. But I did read in Newsweek that the President very definitely opposed that as being impractical.

My next question is, you said a moment ago that balancing the budget or a balanced budget proposal at the time of a recession would be counterproductive.

Do you suppose there will be no recessions after your amendment becomes part of the Constitution?

Secretary **REGAN**. Let me come back to that.

First of all, let me say something for the record. I was not sure—and unfortunately, time expired—when Mr. Stark was talking about his $50 billion defense cut, whether he meant that amount per year or whether he meant over a 3-year period. The President and members of his negotiating team were discussing a $39 billion cut over 3 years.

Mr. **JACOBS**. Mr. Secretary, you are very kind to accommodate me. That is a barrel of snakes that we are talking about. I am asking you a specific thing. You said a moment ago——

Secretary **REGAN**. I am coming back to answer that. Let me answer that question. But just for the record, I wanted to make sure of your opening remark.

As for the balanced budget amendment, in the outyears when there is a recession, there are ways that you can have an unbalanced budget, even though there is a constitutional amendment. It is by three-fifths of the Members of both Houses agreeing to it. You can also raise taxes by a majority vote of both Houses.

Mr. **JACOBS**. So, what you are saying is that it really is not much of an amendment. As soon as somebody decides there is a little trouble in the economy, it is not really too much trouble to unbalance the budget; is it?

Secretary **REGAN**. What we are saying is that it would require the supermajority of this Congress to decide to unbalance the budget. If the supermajority decided that was in the interest of the country in future years, they would do it.

Mr. **JACOBS**. You are a very busy man, Mr. Secretary, but do you remember our telephone conversation last summer when you solicited my support for the Laffer curve for your tax program?

Secretary **REGAN**. Well, that was not the Laffer curve. That was then called the Kemp-Roth——

Mr. **JACOBS**. I would call it the laughable curve myself. But whatever it was called, do you recall when I asked you what you were going to do with the big deficits your tax program would produce, that you told me it would produce a bull market by Labor Day; and that you knew a way to handle a deficit that wasn't inflationary? Do you remember that?

Secretary **REGAN**. Well, I do not recall the "bull market by Labor Day" statement.

Mr. **JACOBS**. You do not?

Secretary **REGAN**. No.

Mr. Jacobs. Well, do you recall my saying that I knew you could handle a deficit without inflating the economy, but the only way you could do it was to drive it toward a depression by driving interest rates sky high?

Secretary Regan. You did say something of that nature, but again, yours was just one of many calls I made. And I do not have a precise recollection of it.

Mr. Jacobs. I like to think I was the linchpin of the effort. But I would simply say that you mentioned that only 2½ percent of the cuts have gone into effect. But I would point out to you that when you had your champagne celebration after you rolled us on the floor with our committee tax bill at the end of July, the boast was that the anticipation of the tax cuts would drive people into the market and cause it to be a bull market.

Do you recall that? It was not contingent on the reality.

Secretary Regan. I will check the record to see what I said about a bull market back there. But I am usually pretty cautious about predicting bull markets.

Mr. Jacobs. You just said in your testimony that you are very bullish about everything.

Secretary Regan. No, no. I said I was bullish. That was in answer to Mr. Heftel. I said I was bullish on the fact that we could get together—the Congress and the administration.

Mr. Jacobs. I think I tend to agree with some of the other statements that were made, including yours. There is a lot of bull in all of this exchange that has gone on.

Secretary Regan. There is enough bull on both sides of the aisle.

Mr. Jacobs. Right.

Chairman Rostenkowski. Mr. Secretary, I want to thank you for joining us here today. I want to make the observation that you are playing a dangerous game with the fortunes of the country. I maintain that the President must provide strong leadership, and that there will be a favorable reaction if the President presents a budget that is real. I acknowledge that the budget negotiations produced agreement on the size of the projected deficit as opposed to a detailed blueprint outlining a precise plan of how those deficits are to be reduced. However, I would like to see the end of the political gamesmanship in the very near future. I think the American people will demand this of all of us.

As I said earlier, we will be required to cast some courageous votes here. In my opinion, there is need for a new budget recommendation from the President. I understand that Mr. Stockman retreated to the February budget document when he testified before the House Budget Committee. In my opinion, this does not represent progress, but rather retreat, from where we were in the budget negotiations.

I only want to make the observation that there was not the vociferous reaction as there was a year ago to the President's clarion call to the American people to call their Congressmen in support of the President's budget. That has been observed by most members not only of this committee but of Congress. And so, the Congress will wait for an initiative on the part of the administration.

Mr. Domenici has come up with a bold program which I question whether the Senate will accept. However, I commend him for his leadership in this area. I hope that when the dust settles, we will have a responsible budget document from which to work.

Mr. Secretary, the White House and this administration cannot escape accepting responsibility for the recession.

I would just close by quoting one statement that my good friend Don Regan made in February. On February 2, as reported by a New York newspaper, the Secretary is quoted as saying, "The administration will take the blame or the credit. I take the credit for what happens in the economy."

Mr. Secretary, that sword has two edges. I just hope that you and I and a majority of this committee can sit down and work out what we think is necessary to strengthen the American economy.

I will not say that the third year individual tax cut is on or off the table. I think it is a negotiable item. Although we do not have the jurisdictional authority in this committee to legislate in the area, I will not say that defense cuts, are on or off the table. I think what the American people expect from us is that we address the problem and do our work.

Mr. Secretary, I thank you very much for testifying today. I know that it has been a long day for you. I hope that you have success in traveling that extra mile down to 1600 Pennsylvania Avenue this afternoon.

Secretary REGAN. Thank you, Mr. Chairman. I appreciate all the courtesy that the members of this committee have shown me today. I think that not only do I share your concern for the economy, but I also share your belief that there is a way to work this out.

As I said in one of my answers earlier, I think when this time of rhetoric, when this time of finger pointing and the like is over, we will be able to sit down quietly and work this out. The country demands it. The economy needs it. And I think as much as we can in a political year we should try to come up with some bipartisan arrangements to accomplish this.

And I assure you, Mr. Chairman, I will spend every moment I can at this. I will stand ready at any time to meet with you and other members of this committee to work toward that endeavor.

Chairman ROSTENKOWSKI. Safe journey. Thank you.

Secretary REGAN. Thank you. And I will report your solicitation.

[Whereupon, at 1:20 p.m., the hearing was adjourned.]

○